

NOTE

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USE OF SINKING FUNDS, &c., FOR CAPITAL PURPOSES

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PREFACE

However incomplete our work may be judged to be, it would be sadly incomplete if we did not, as we do here, express our grateful acknowledgments to those Chief Financial Officers who have assisted us by completing the somewhat involved questionnaire with which we burdened them, and in particular to Messrs. J. D. Imrie, William Aiken, F. G. Bowers, A. B. Griffiths, Sydney Larkin, Alfred Riley and C. G. Garratt-Holden, who have given us invaluable advice and help at various stages of our work.

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The Use by Local Authorities of Sinking and Redemption Funds, Reserve Funds and Superannuation Funds, &c., for their own Capital Purposes

A.—INTRODUCTION

1. In Great Britain, borrowing is resorted to by local authorities generally for the purpose of financing expenditure which it is inexpedient to charge direct to current revenue, either on account of its magnitude or because of the nature of the purpose. Subject to certain few exceptions, a local authority may not borrow money except with the express sanction either of Parliament given in a Local Act, or of a Government Department acting under powers conferred by a general or Local Act of Parliament. In either case, the sanction is invariably coupled with an obligation to repay the loan fully within a fixed period, which is determined broadly on a cautious estimate of the effective life of the asset acquired by the expenditure of the borrowed money. Provision for repayment forms an annual charge to revenue during the period of the loan, and this inflexible principle of amortisation of loan expenditure, which may be incurred only with the approval of a superior and discretionary sanctioning authority, makes a substantial contribution to the recognised soundness of the finances of British local authorities.

2. The power to borrow is strictly controlled by Parliament and the Government Departments, but the methods of borrowing are left largely to the discretion of the local authority, acting within the limits of certain codes laid down by Parliament. The principal methods by which borrowing powers are exercised by local authorities in England and Wales are as follows:—

(1) By the issue of *Redeemable Stock*, either under the authority of Local Acts, or, as is more common, under the Stock Regulations, 1934—a common code which, under the Local Government Act, 1933, regulates issues of stock by councils of counties and county boroughs, boroughs, urban districts and rural districts. This method is frequently employed for the raising of large sums, by county and county borough councils, and to a smaller extent by

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the larger non-county borough and urban district councils. Although within certain limits stock may be issued privately, the usual procedure is to make a public issue through the medium of the London Money Market, on the basis of an advertised prospectus detailing the terms and redemption date(s) of the stock.

(A few local authorities obtained powers many years ago to issue Irredeemable Stock, *i.e.*, stock which cannot be compulsorily redeemed by the local authority, but examples of such issues are rare.)

(2) By the issue of *Mortgages* secured generally on the rates and revenues of the local authority, a method which is appropriate to all types of local authority, and commonly used by all, in many cases to the exclusion of other forms of borrowing. Whereas stock is issued for relatively long periods, with a maximum of 60 years, mortgages are issued for periods varying from 3 years or less to a general maximum of 60 years. There are many instances where a local authority find it possible to satisfy a substantial proportion of their capital requirements by borrowing by this method from private investors; other sources from which money is borrowed on mortgage are the banks, insurance companies and similar institutions, and (in the case of the smaller authorities) the Public Works Loan Commissioners.

(3) By the issue of *Debentures, Debenture Stock and Annuity Certificates* under the Local Loans Act, 1875. Comparatively little use is now made of this Act, owing to its restrictive provisions, although securities have been issued under it by the City of London Corporation.

(4) By the issue of *Housing Bonds* under the Housing Act, 1925, for the purpose of raising moneys for financing housing expenditure only. The Housing Bond is a special form of mortgage, issuable for a minimum period of five years, by councils of counties, county boroughs, boroughs, urban districts and rural districts.

(5) By the issue of *Bills*, under Local Act powers granted to a small number of the larger local authorities; by this method moneys are borrowed temporarily, *e.g.*, pending the raising of a long-term loan, the currency of the bills seldom exceeding one year.

(6) By the issue of *Corporation Bonds*, also under Local Act powers. The Corporation Bond resembles the Housing Bond, with the important distinction that the proceeds of issue may be employed for *any* authorised capital purpose of the local authority.

(7) By *Bank Overdraft* or other method of temporary borrowing pending the raising of a long-term loan, under the general authority of Section 215, Local Government Act, 1933.

(8) By the *Use of the local authority's own Sinking and Redemption Funds*, and of their Reserve, Superannuation, Insurance and similar funds, as fully described in Section C of this Report.

In Scotland, borrowing proceeds upon the same general lines as in England and Wales. Apart from certain issues of stock under the Local Authorities Loans (Scotland) Acts, 1891-1924, issues of stock are usually made under Local Act powers. The "backbone" of local authority borrowing, however, is to be found in the short-term mortgage, although present-day interest rates tend to increase the periods of years for which such mortgages are issued. Borrowing by temporary loans, for which certain statutory powers have existed for many years, provides something of a distinctive feature in Scottish loan finance, particularly that of county councils. Usually

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a simple receipt is granted, but in some cases there is also an undertaking to issue a mortgage if and when required by the lender. Power to issue Bills and Promissory Notes exists in a limited number of cases, while the position as to Housing Bonds and loans from the Public Works Loan Commissioners is broadly the same as in England and Wales.

3. The most popular methods of borrowing are by the issue of Mortgages and Stock (and, for the special purpose of Housing, of Housing Bonds), but whatever method is adopted, the statutes require that provision must be made in every case for repayment of the loan by annual charges to revenue during a term of years not exceeding the period fixed by the sanctioning authority. The methods of repayment authorised by the statutory codes are as follows:—

(1) The instalment of principal system, under which an equal yearly or half-yearly instalment of principal is repaid to the lender throughout the prescribed period for the loan, together with the interest on the amount of the loan outstanding from time to time.

(2) The annuity system, under which an equal yearly or half-yearly sum to cover both principal and interest is paid to the lender throughout the prescribed period for the loan.

(3) The sinking fund system, under which such a sum is set aside to a fund each year as will be sufficient to repay the loan within the prescribed period for the loan. A sinking fund may be either (i) accumulating, *i.e.*, formed by annual contributions which are set aside and invested, at compound interest, so as to produce the required sum at the end of the period, or (ii) non-accumulating, *i.e.*, formed by setting aside an equal annual contribution which, without interest thereon, will provide the required sum at the end of the period.

The choice of method is generally within the authority's discretion, except that in certain forms of borrowing, of which stock is the most important, the sinking fund method is obligatory. In fact, the sinking fund method is applied to the majority of loans.

4. At this stage it may be explained that the statutory conditions as to the repayment of loans must be construed in two rather different though reconcilable ways, *viz.*: (1) that the amount borrowed by the local authority from the lender must be repaid to the lender not later than the end of the sanctioned period, and (2) that the local authority must provide out of revenue moneys during the period of the loan sanction the amount so borrowed. In effect, while the loans raised must be repaid on the dates agreed with the lenders, the capital or other expenditure which the borrowed money finances *ab initio* may be redeemable over a period which differs materially from the periods for which the money was originally borrowed. The distinction to which point is given here may be expressed as one between the raising and repayment of a loan—which is a matter of contract between local

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authority and lender—on the one hand, and the incurring and discharge of capital expenditure—which is a matter of the expenditure of borrowed money and of the provision to meet it out of revenue—on the other hand. The recognition of this distinction has prompted the modern development of the technique of loan management which has lately found expression in the Consolidated Loans Fund. This device will be fully described later (paras. 30-32), but in the meantime the distinction mentioned above may be illustrated by simple examples. The distinction is *not* apparent where the loan is raised on terms of repayment which are exactly coincident with the loan sanction, as is the case with the typical “instalment loan” of a small local authority and with all loans raised from the Public Works Loan Commissioners, but it is clearly exemplified in the case of the many stock issues which were made in the years 1920-1921, for periods of 15-20 years, the proceeds of which were applied to purposes (chiefly housing sites and buildings) for which loan periods of 80 and 60 years were authorised. It is obvious that in such cases the stock sinking funds formed by the annual contributions made by the borrowing services—on 80- and 60-year computations—will be inadequate to provide funds for the redemption of the stocks at the maturity dates. It will, therefore, be necessary to re-borrow the deficiency in order to redeem the stock, while the annual contributions will continue to be made by the borrowing services—in *discharge of the capital expenditure rather than in repayment of the loan*.

5. It is apparent, then, that the creation by local authorities of sinking and redemption funds arises from the obligation which attaches to all their borrowings to make provision, generally during the life of the assets acquired by the expenditure of the borrowed moneys, for the repayment out of revenue moneys of the sums so borrowed and expended. In cases where loan expenditure is met out of moneys borrowed on terms which provide for repayment to the lender by instalments of the principal sum during the period of the loan (on either the instalment or the annuity basis), there is, of course, no sinking or redemption fund. Such loans are usually “earmarked” for the particular purpose of the statutory borrowing power in the exercise of which they are raised; and they do not fall within the scope of this inquiry, although they attract certain observations on the subject of “earmarking” (para. 31), which, though obsolete in theory, still exists to a considerable extent.

6. The sinking fund (or redemption fund—the terms are synonymous), which was first applied as a principle to the National Debt in 1716 by Sir Robert Walpole, was imported into the system of

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municipal borrowing by the Commissioners Clauses Act, 1847, and improved in form by the Public Health Act, 1875. It was introduced as an additional means, alternative to the established instalment and annuity methods, of providing for repayment of loans, and it was in accordance with the truest conception of the sinking fund attached to the National Debt—that moneys paid thereto should not be diverted to any purpose other than the ultimate repayment of the debt—that in its application to local authorities the sinking fund was required to be invested in Government securities. It was not long before those local authorities which had raised loans on the sinking fund method of repayment realised that, in comparison with loans repayable by the instalment or annuity method, their gross indebtedness was inflated by the existence of the sinking fund, and that they were creating new loans on the one hand at the same time as they were investing large sums in outside securities on the other. It was then but a short, though nevertheless important step—by way of local legislation and, later, by way of amendment of the Stock Regulations—to the utilisation of sinking fund moneys for new capital purposes, and there are to-day few of the larger local authorities which do not, either directly or indirectly, wholly or partially, use their sinking funds in this way. It may perhaps be said that this user of sinking funds by local authorities has given a new meaning to Byron's lines:—

“ The Sinking Fund's unfathomable sea,
That most unliquidating liquid, leaves
The debt unsunk, yet sinks all it receives.”

—(1824, *Don Juan*, Canto XVI, xcix.)

7. Sinking funds, which are inherently related to indebtedness, differ in that important respect from the other funds embraced by this inquiry. These other funds chiefly comprise reserve funds, superannuation funds and insurance funds. Reserve funds set up in connection with trading undertakings of local authorities are generally required under the law to be invested in statutory securities other than those of the local authority itself. It is only where powers have been obtained under Local Act that reserve funds may be used internally. A superannuation fund established under the general authority of the Local Government and Other Officers' Superannuation Act, 1922, may, subject to certain conditions as to repayment, be used for the statutory borrowing purposes of the local authority and, in general, similar remarks apply to superannuation funds set up under Local Act powers. Insurance funds, capital funds and capital reserve funds are creations of local legislation, under which their internal user is as a rule permitted. There is also the housing repairs fund, now

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governed by the provisions of the Housing Act, 1935, in terms which include the power of internal application in the exercise of statutory borrowing powers.

8. The main objects of this investigation have been to inquire into the history of the practice of internal user and its present extent, to test the validity of the criticisms which have been levelled at it from time to time and to examine how far, if at all, it is desirable that it should be extended. The necessity for safeguards against dangers and abuse, and the preservation of the interests of the parties concerned, have also been considered. The inquiry has been extended, in connection with the issue of stock and the utilisation of stock sinking fund moneys, to a consideration of the terms of stock prospectuses, and certain observations are submitted with regard to the "redemption clause," which is an important feature of the prospectus.

9. Unless the context otherwise requires, the following terms are used throughout this report in the sense defined below:—

(a) Report of the Select Committee—The report of the Select Committee of the House of Commons which was appointed in 1909 "to inquire and report as to the powers conferred on local authorities by Local Acts, Provisional Orders, Stock Regulations or otherwise, of utilising for purposes for which such authorities have borrowing powers, Sinking Funds (including loan funds and redemption funds) set aside by them for the repayment or redemption of loans raised by the issue of stock or by any other method; as to the expediency or otherwise of such powers being conferred; and as to any conditions which it is desirable to attach to the granting or use of such powers."

(b) Local Authority funds—the following definition was used in the questionnaire which, in the course of this inquiry, was issued to a representative selection of 60 local authorities in Great Britain (see Section C and the Appendix): "The expression 'Local authority funds' should be taken to include Reserve, Superannuation and Insurance Funds. Funds set up for the purpose of equalising rate charges need not necessarily be included, and Sinking and Redemption funds should be excluded except where there is no loans pool, and earmarked Sinking or Redemption funds are invested with other departments or used for new capital purposes. In such cases, they should be included." It will be observed that where a loans pool exists Sinking and Redemption funds are excluded for the reason that they do not exist.

(c) Loans pool—a real Consolidated Loans Fund.

(d) Model Scheme—the Model Scheme of Loan Consolidation prepared in 1929 by the Institute of Municipal Treasurers and Accountants (Incorporated) in consultation with the Ministry of Health. (This sets forth the principles upon which a loans pool should be operated.)

(e) Internal use—Use of funds by a local authority itself as distinct from outside investment.

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(f) Real reserve—liquid funds possessed by or available to an authority for the purpose of meeting maturing debt (including calls by Local Authority funds).

The following abbreviations are used:—

(g) Act of 1922—Local Government and Other Officers' Superannuation Act, 1922.

(h) Accounts Order, 1930—the Accounts (Boroughs and Metropolitan Boroughs) Regulations, 1930 (S.R. & O., 1930, No. 30).

B.—HISTORICAL REVIEW AND DEVELOPMENT OF LAW AND PRACTICE RELATING TO THE INTERNAL USE OF LOCAL AUTHORITY FUNDS

(I) *Sinking and Redemption Funds.*

10. For a starting point in an inquiry as to the historical development of the practice of using sinking funds for capital purposes it is not necessary to go further back than to 1909, when the report of the Select Committee was published (Cd. 193, 1909). This report forms such a valuable contribution to the subject that it is thought worth while to describe its contents somewhat fully.

11. Evidence was received by the Select Committee "from witnesses representing the Local Government Board, the Scottish Office, and the Public Works Loan Commissioners; from the Counsel to the Chairman of Committees of the House of Lords; from witnesses representing the Stock Exchange; and from witnesses representing the London County Council, the Municipal Corporations, and other Local Authorities." After relating the methods of repayment of debt adopted by local authorities, and the conditions governing the issue of stock, the Report proceeds with a description of the history of provisions in Local Acts and in the Local Government Stock Regulations, enabling local authorities to use sinking funds for new borrowing powers.

12. The Metropolitan Board of Works (predecessors of the London County Council) were "the first municipal authority to obtain from Parliament powers to use the moneys of the sinking fund in the exercise of borrowing powers." In 1881 the Board were given power to advance to local authorities, out of stock sinking fund moneys, loans for periods not longer than 30 years; "in 1884 the restriction to 30 years for loans out of the fund was removed," and in 1885 Parliament approved "an extension of this plan in the direction of expenditure incurred by the Board on improvements the cost of which could not fairly be spread over the full term for which Metropolitan Stock is created." In its final form this power provides that the sinking fund may be lent or used for capital purposes, duly authorised, on the condition that the money so lent is repaid to the

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fund before the time when it would be required for redemption purposes.¹

13. The earliest provision affecting municipal corporations was the Birmingham Corporation Water Act, 1892, which permitted "borrowing from the Loans Fund for new capital purposes, following the method adopted in the London Acts. The approval of the Local Government Board was required, and provision was to be made for repaying to the fund the money so borrowed in a manner to be approved by the Board." But the modern practice of utilising stock redemption funds by "transfer of stock" "from the account of one borrowing power to the account of another borrowing power," had its origin in the Liverpool Corporation Loans Act, 1894; while the Leicester Corporation Act, 1897, contained fuller provisions which became the model for subsequent powers to use redemption funds of stock created under Local Acts.

14. In 1898, St. Helens Corporation obtained powers from Parliament enabling them to use for new borrowing powers the redemption fund established for the redemption of stock issued under the Local Government Board's Stock Regulations, and in 1901 the Board amended those regulations by inserting provisions enabling local authorities generally to use their stock redemption funds in the exercise of borrowing powers.

¹ It is relevant here to refer to the following note (which is published in "The London County Council from Within," by Sir Harry Haward) of an interview which representatives of the London County Council had with the Chancellor of the Exchequer (Viscount Goschen) in 1889, as a result of which the London County Council were granted this power:

"The Chancellor expressed his own opinion in favour of a restriction rather than an expansion of Trustees' Investments generally. He referred to the proposal of the Metropolitan Board of Works to 'invest its Sinking Fund in its own securities,' and said, 'two years ago he was against the proposal of the Board in principle though he allowed it for one year, but now, after seeing the difficulties of the position, he was in favour of it as being the more economical and the soundest course to adopt, inasmuch as it would check the growth of loans and do away with the necessity of creating stock on the one hand and investing largely in securities on the other.' His only hesitation had been that he was not clear that the asset of the Sinking Fund would remain good and complete, but it had been explained that no matter where the money was borrowed, whether from the Sinking Fund or the public, the interest and annual instalment would be charged on the rate, and the fund practically remain the same. He preferred that the Council should invest in its own rather than in outside securities. He would ask 'whether the Council would prefer a power to invest in its own securities rather than an extension of securities outside itself.' To this it was replied that the power to use the Sinking Fund for purposes up to 60 years, pending its application to redemption of stock, might do for a few years, but there would still be a need of a better option of investment. As the Council approached 1929 or 1941, the number of years over which the new capital expenditure on, say, a street improvement, if defrayed out of the Sinking Fund moneys, would have to be repaid, would be too much diminished owing to the nearness of the date of termination of each stock. The Chancellor of the Exchequer said he was not sure that an immediate loss on purchase of stock was not better than an accumulation of securities. He wished the matter to be further considered by the Council in the light of the interview and stated that he would do the same."

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15. In Scotland the powers to use any loans fund or sinking fund in the exercise of borrowing powers dates from 1883 in the case of Glasgow, and 1897 in the case of Edinburgh. In each case the power is an unrestricted user of sinking or redemption fund moneys by way of loan to the borrowing fund, such advance to be repaid within the period for which the loan is sanctioned. In addition, the Burgh Police (Scotland) Act, 1903 (a general Act), permits the *temporary* user of sinking fund balances for the purpose of defraying either current or capital expenditure.

16. The permitted use of sinking funds thus takes alternative forms. In the case of the London County Council, "there is merely a user of the money lying in the sinking fund." Each use of the sinking fund for capital purposes is treated as if it were a loan to the appropriate capital account of so much money, and the appropriate account is charged with the repayment of that loan at interest at the current rate which would have been payable if stock had been issued for the purpose. The approval of the Treasury to such use must be obtained, and the moneys must be repaid at, or before, the date at which the stock to which the sinking fund relates has to be redeemed, and within a period approved by the Treasury, not exceeding 60 years. In the case of municipal corporations having Local Act powers, and of other local authorities which are subject to the Stock Regulations, the method is by way of transfer of stock from the old borrowing account to the new borrowing account (but see paras. 30-32 as to "Consolidated Loans Fund"). An amount of stock equivalent to the amount of the redemption fund applied to new capital purposes is treated as having been redeemed in respect of the old purpose, and as having been re-created in respect of the new purpose. In general, the consent or approval of the Local Government Board (now Ministry of Health) is required. But there is no condition that the redemption fund must be restored to its full amount on or before the date when the stock has to be redeemed.

17. *Mortgage Sinking Funds.*—Power to use mortgage sinking funds for new capital purposes was first obtained by St. Helens Corporation in 1898. A common sinking fund was to be set up, "ear-marking" of mortgages to any particular fund was to be abolished, and "the general effect was to establish a system of repayment of debt as a whole instead of specific loans under specific powers." Under the powers given to the St. Helens Corporation, and later to other corporations, the consent of a Government Department is not required to the specific utilisation of mortgage sinking funds for new capital purposes; they may, of course, only be used in the exercise of statutory borrowing powers.

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18. The witnesses who gave evidence before the Select Committee in support of the use of sinking funds in the exercise of new borrowing powers claimed that it afforded an easy method of borrowing without adding to the total outstanding debt of the local authority, and thus avoided the expense of fresh borrowing to that extent. It was not always possible to apply a sinking fund in the purchase of stock for extinction, which in any case involved expense, and the alternative of investing the fund must also involve expense and, possibly, loss through depreciation of investment. Substantial savings might result from the use of the sinking fund for new capital purposes, because in addition the price at which stock could be purchased for extinction would be greater than the issue price of new stock. While the power would be more valuable in unfavourable borrowing conditions, it was not likely to be exercised if new loans could be raised on better terms.

19. Opposing witnesses raised the following objections to the principle and practice:—

(1) That it amounts to a breach of contract, on the ground that the usual reference in a stock prospectus to the formation of a " sinking fund for the redemption of the stock " at the least created an impression in the mind of the investing public that a sinking fund really existed for the purpose of redeeming the stock at maturity.

(2) That Corporation credit would suffer if the practice became generally known.

(3) That if a number of corporations came on the market together during a period of financial stringency for the replacement of stocks which would otherwise have been redeemed out of sinking funds, the monetary crisis would be intensified, with serious reactions on the money market and on corporation credit.

(4) That it is liable to encourage reckless finance, as the money is obtained easily, without any warning to the ratepayers of the new expenditure.

(5) That (according to one witness) the sinking fund should be applied regularly in buying stock, thereby providing a market for any small investor wishing to sell; and that the regular application of sinking funds would, by keeping up the price of the stock and affording evidence of fulfilment of the implied contract, improve the corporation's credit.

20. The Select Committee dealt with these objections in detail as follows:—

(1) If a stock prospectus contains a definite undertaking to apply the sinking fund in the purchase and cancellation of the stock, any other use of the fund would be a breach of contract; but in only one prospectus submitted to the Committee was such an undertaking given. Otherwise, the stockholder is not prejudiced by the temporary use of the fund pending redemption of the stock. In any case, " the real security of a lender to a corporation is the rates and revenues on which the stock is charged "; the object of requiring the corporation to establish sinking funds is not, primarily, to add

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to the lender's security, but to spread the burden of the stock equitably over present and future ratepayers. A reference in a prospectus to the establishment of a sinking fund shows "that the corporation will continuously lay aside sums to liquidate its debts, thus indicating that its finance is sound and its credit free from reproach." Further, "the sinking fund forms no part of the legal security of the lender."

(2) As pointed out by the local authorities' witnesses, in justification for their view that corporation credit would not suffer if the practice became generally known, the local authority's financial position is not weakened by the transaction—the total indebtedness and ability to discharge obligations are the same, whether the fund is used or a new loan is raised.

(3) While the possible danger of several corporations having to re-borrow coincidentally during a period of financial stringency may be regarded as an objection to the use of sinking funds for periods beyond the stock redemption dates, it does not apply to cases where the fund is replaced before the stock matures.

(4) The suggestion that the practice encourages reckless finance is untenable; borrowing is permitted only for purposes authorised by Parliament or by a Government Department, and once sanction is given, after proper inquiry, the local authority should be free to raise the money required in the most convenient and economical manner at its command.

(5) As pointed out by the local authorities' witnesses, it is not always possible to apply sinking funds in purchase of stock, except at prices unduly forced up as the result of the local authority's purchases, while there is also a natural disinclination to purchase for cancellation stock which stands above par. As to the alternative of investing the sinking fund in statutory securities, "there is an objection to piling up large investments in outside securities on the one hand, and issuing fresh stock on the other," partly on account of the risk of loss through depreciation of investments.

21. The Select Committee finally came to "the conclusion that the general principle involved in the application of sinking funds in the exercise of borrowing powers is financially unobjectionable," but that it was necessary to consider carefully the application of the general principle to particular cases and in particular ways. The full summary of their conclusions, as set out in the Report, is as follows:—

"(1) The principle of utilising sinking funds (including loans funds and redemption funds) for purposes for which local authorities have borrowing powers is, if properly safeguarded, financially unobjectionable; and the power of so using these funds is undoubtedly a great advantage, inasmuch as it affords a convenient and economical method of exercising new borrowing powers.

"(2) In those cases in which the stock is required to be extinguished at a fixed date, your Committee are of opinion that any amounts withdrawn from the fund should as a general rule be replaced by that date, and that any departure from this principle should require the previous consent of the Local Government Board.

"(3) While satisfied that the ordinary method, prescribed in Local Acts and by the Stock Regulations of the Local Government Board, of utilising loans funds or redemption funds, set aside for the repayment or redemption

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of loans raised by the issue of stock, is theoretically free from objection, your Committee feel a preference for the system prescribed by the London County Council (Money) Acts, in so far that the system involves the approval of a Government Department as a necessary precedent to the exercise of the power, and requires that all moneys used from the funds must be replaced before the expiration of the life of the stock. At the same time we recognise that this last condition may operate disadvantageously during the latter part of the life of the stock.

" (4) With regard to the operation of the system prescribed by the Local Acts and Stock Regulations, your Committee are of opinion that, while in the majority of cases there may be no real objection to the transfer of stock at par value, nevertheless there should be some limitation to prevent the transaction working unfairly as between different accounts; and we suggest that with this object the Local Government Board should take such administrative action as we have previously indicated.

" (5) Your Committee consider that a loans fund set aside in respect of loans raised by Irredeemable Stock may, subject to proper restrictions and conditions, be utilised for borrowing powers.

" (6) With regard to sinking funds set aside in respect of loans raised on mortgage, the funds should not be used for borrowing powers where the mortgage earmarks the borrowing power under which the loan is raised; and where a loan is by the mortgage charged on specified rates or revenues, the sinking fund should not be used for any borrowing power under which the loan is required to be charged on different rates or revenues.

" (7) Sinking funds set aside in respect of loans raised under and subject to the provisions of the Local Loans Act, 1875, should not be used in the exercise of borrowing powers.

" (8) Returns should in every case be made to the Local Government Board clearly showing:

- (i) The amount of the sinking funds, loans funds, or redemption funds, invested, and the securities in which investments have been made;
- (ii) The amount of stock or debt cancelled; and
- (iii) The amount applied in the exercise of borrowing powers. Moreover, the accounts should be audited by an independent auditor, who should make a special report in every case in which he is of opinion that there has been any irregularity in the transactions of the local authority in regard to the use of the sinking funds or to the provisions made for the repayment or extinction of debt.

" (9) The terms of prospectuses should be strictly adhered to and reasonable information as to the contributions to and management of the sinking funds should be placed at the disposal of the ratepayers of the locality, and, where stock has been or is proposed to be issued, of the Stock Exchange."

22. It will be observed that among the objections raised to the principle and practice of the internal use of sinking and redemption funds was that such a use amounts to a breach of contract, *e.g.*, where a stock prospectus provides for the formation of a sinking fund, which is expressly or by implication to be used in actual purchase of stock. The Select Committee agreed that where there was a definite

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undertaking to apply the sinking fund in purchasing stock, any other use would be equivalent to a breach of contract. Such undertakings, however, both in the past and at the present time, appear to be of rare occurrence, and as will later be shown (paras. 81 and 93) it would appear that there is no need to give them.

23. The Select Committee stressed the fact that the real security of a lender to a local authority is its rates and revenues, and in their report the inference is drawn that a reference in a prospectus to the establishment of a sinking fund is intended to show that the local authority will continuously set aside sums to liquidate its debts. There are further points as to the possibility of an implied undertaking that sinking funds are to be applied in the purchase of stock, and also as to the desirability of omitting the words "sinking fund," where no sinking fund can, in fact, exist (*e.g.*, in the case of a loans pool). These points are more fully dealt with later (para. 76).

24. In their conclusions, the Select Committee found that the principle of utilising sinking funds for purposes for which local authorities have borrowing powers, is, if properly safeguarded, financially unobjectionable. One of the safeguards which they felt to be desirable was that amounts withdrawn from a stock sinking fund should be replaced before the expiration of the life of the stock. It will be shown later (paras. 77-78) that, apart altogether from any question as to its desirability, this proposed safeguard has not, in fact, been given effect to, the fact being that it is the exception for a maturing stock to be fully repaid out of available redemption funds. The whole question of existing and desirable safeguards against the abuse of the system of internal use of sinking funds is considered in paras. 95-96. It will be found that, outside municipal circles (and apparently to a certain extent even inside municipal circles), the position is not fully understood, and that there is need for a fuller appreciation of the facts. It will also be found that while as a whole the existing arrangements as to internal use of sinking funds are free from serious criticism, there are differences of opinion on certain points and differences in practice² in others. The Select Committee's recommendation that "the terms of prospectuses should be strictly adhered to" attracts further reference in paras. 85-94.

25. *Post-1909 Developments.*—Since the date of the Report of the Select Committee there has been a marked extension of the practice of using sinking funds for new capital purposes. This extension has

² For instance, Section 55 of the London County Council (General Powers) Act, 1924, authorising the internal use of their local authority funds by Metropolitan Borough Councils, still retains a restriction that sinking funds used internally must be fully restored by the maturity date of the original loan. This restriction is consistent with the general policy of the London County Council. (See also para. 12.)

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taken three forms, viz.: (1) the increased user of stock sinking funds by the operation of "Transfer of Stock"; (2) the development of the "mortgage pool," from which "sinking funds" as formerly conceived have been eliminated; and (3) the setting up under Local Act powers of loans pools, covering all debt (with minor exceptions) and involving the complete abolition of sinking funds and redemption funds in respect of both mortgages and stock.

26. *Use of Stock Sinking Funds.*—The use of stock sinking funds for new capital purposes, which had first been generally authorised by the Amending Stock Regulations of 1901, was considerably encouraged in 1921, when the Stock Regulations were further amended so as to provide that transfers of stock on utilisation of sinking funds might be made "at par value, or at such other value as the Minister of Health may direct," instead of invariably at par value. About this time also the theory that a stock sinking fund was a complete security for the redemption of the stock was finally destroyed, for in the years 1920-1921 stocks were issued with a life of 15, 20 or 30 years, of which the proceeds were applied to 60-year borrowing powers. Obviously, in these cases, the sinking fund would be far short at redemption date of the amount required to redeem the stock. Recognition of this fact led also to the realisation that redemption of the stock would be effected by re-borrowing or by conversion (in fact, very few stocks have been redeemed by application of sinking funds—para. 77), and gave further encouragement to the use of stock sinking fund moneys for periods not limited by the redemption date of the stock to which the sinking fund was related. The popularity of this method of financing capital expenditure is attested each year by a paragraph in the Ministry of Health's Annual Report which states the number and amount of Orders which the Minister has issued enabling local authorities to use sinking fund moneys. These particulars, however, relate only to stock issued under the Stock Regulations; in the case of stock issued under Local Act powers the consent of the Minister is not required to enable the use of sinking fund moneys.

27. *Mortgage Pools.*—Many local authorities have followed the St. Helens precedent of 1898 (para. 17) and obtained powers to issue a common form of mortgage with a common sinking fund, coupled with the power to use sinking fund moneys for new capital purposes, thus replacing the earlier method of borrowing specific loans on mortgages definitely earmarked to the purposes of particular borrowing powers. The approval of the Minister of Health is *not* required for such user. It became a common practice for local authorities to borrow on mortgage for short terms which had no relation to the borrowing

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power periods, and it was realised that the investment of mortgage sinking funds was both unnecessary and expensive: unnecessary, because borrowing by short term mortgage developed into a popular and continuous process, and new moneys were always available for repayment of maturing mortgage loans, apart from the availability of the common sinking fund to meet repayments; expensive, because of the costs of making investments, which, it was readily seen, could be avoided by utilising the sinking fund moneys and thus saving further costs on raising new loans! Thus the "mortgage pool" was established; into this pool flowed all new loans and "sinking fund" contributions, and out of it were paid "advances" to the various "borrowing accounts" and loan repayments on maturity of mortgages. In effect, the sinking fund is eliminated where a mortgage pool operates. It appears that in many cases mortgage pools have been set up without Local Act powers to use mortgage sinking funds for new capital purposes, on the assumption that "the establishment of the principle that loans are not earmarked removes all need for any statutory powers to transfer sinking funds to new capital purposes. This power flows automatically from the pooling of loans. There must be no misconception: loan pooling in itself frees the sinking funds" (Mr. A. Carson Roberts, at the I.M.T.A. Conference, 1923).

28. In England and Wales a "general loans pool" is now, however, prescribed (for certain local authorities, and, by implication, permitted for all other local authorities) by the Accounts Order, 1930 (Art. 9 and Second Schedule), in respect of mortgages or bonds which are available in law for the purpose of (i) all or any of the authority's statutory borrowing powers, or (ii) all or any of the statutory borrowing powers under a particular enactment. In Scotland, too, power to operate a loans pool appears to be a reasonable implication of the provisions of Sec. 23 of the Local Government (Scotland) Act, 1929.

29. In passing, it may be remarked that the general law on the subject of borrowing and repayment of loans, as now enacted in Part IX of the Local Government Act, 1933, is expressed in terms which do not clearly recognise the modern development of borrowing technique, in which the borrowing and repayment of money are divorced from the application of capital moneys in the exercise of sanctions and their subsequent discharge out of revenue moneys. Although it must apparently be presumed that the major statutory authority governing the "general loans pool" prescribed by the Accounts Order, 1930, is to be found in Sec. 213, Local Government Act, 1933, this section contains no clear expression or implication in favour of any other use of unapplied mortgage sinking funds than

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of investment in statutory securities—other than securities created by the local authority! Moreover, the Local Government and Public Health Consolidation Committee reported that they had “considered whether provision should be made in the Bill (*i.e.*, the Bill which became the Local Government Act, 1933) for enabling local authorities to use for any purposes for which sanction to raise a loan has been given moneys which form part of a sinking fund but are not for the time being required”; but, while appreciating “that the power is in certain circumstances a valuable one,” they thought that “to confer it indiscriminately on local authorities of all types would not be appropriate to a Bill of this kind” (*i.e.*, a consolidating Bill, Cmd. 4272, 1933, P. 91).

30. *Loans Pool*.—The development of the modern view that a local authority is one complete entity rather than an aggregation of separate departments, and that its loans should, therefore, be regarded as a whole rather than as a series of separate borrowings, led to the evolution of the idea of a real loans fund or loans pool, including stock as well as other loans. While it is understood that Edinburgh had implied powers to establish such a loans fund as far back as 1894 (and did, in fact, operate a loans fund from that date), the first corporation to obtain statutory powers for this purpose was Torquay in 1923. Dundee, in 1927, actually established the first statutory loans fund, in terms of a Local Act of 1926, which embodied regulations for the administration of the fund. The first fund to be established in England was that approved by the Minister of Health for the Leeds Corporation in 1927; the provisions of that scheme were fully explained to the Committee of the London Stock Exchange, who accepted an assurance that the principle of a consolidated loans fund does not prejudice the interests of stockholders. For the guidance of local authorities a model scheme (based on the Leeds scheme) was prepared in 1929 by the Institute of Municipal Treasurers and Accountants, in consultation with the Ministry of Health.

31. In a loans pool the principle of pooling is fully applied except as to certain loans which are special in character, *e.g.*, loans from the Public Works Loan Commissioners and other instalment loans, and local (housing) bonds. (The exclusion of P.W.L.C. loans and other instalment loans is due to the fact that such loans are “earmarked” to specific borrowing powers, and, moreover, there is little or no advantage to be gained by pooling them with general loans. Housing bonds are excluded because they are issued specifically for housing purposes, being secured not only upon the rates and revenues, but also on the *property* of the local authority, and the loans are not

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available for general purposes.) A single pool is established into which all capital moneys,⁸ from whatever source, are paid, including borrowings of all descriptions and moneys applicable to repayment of debt. From the loans pool loans are repaid, and advances are made as required to departmental capital accounts in the exercise of statutory borrowing powers. The fund acts as an intermediary between lenders and borrowing departments of the authority. Its operation, therefore, effects a complete dissociation of (i) the raising and repayment of loans, in which the pool is concerned in *external* transactions with lenders, from (ii) the exercise and discharge of borrowing powers, in which the pool is concerned in *internal* transactions with the borrowing accounts.

Since contributions by borrowing departments towards repayment or liquidation of capital expenditure are made direct to the loans pool, it follows that all sinking fund accounts are eliminated, and, in fact, that there are no sinking funds. The amount of interest paid by the loans fund is in general recovered by means of proportionate contributions (at the average rate paid by the fund) charged to the various borrowing accounts. (See also, however, the footnote below.)

32. In conceding approval to the principle of the loans pool, Parliament has finally recognised the true nature of the so-called sinking or redemption fund contributions, viz., that they measure the annual provision required to be made out of revenue in liquidation of expenditure which has been financed out of borrowed moneys, in accordance with the principle that all expenditure of local authorities must, sooner or later, be met out of revenue; and that they bear no direct relation to the repayment of the moneys borrowed to finance the expenditure so discharged. In place of any provision as to sinking or redemption funds, the model scheme contains a direction that "the authority shall so administer the capital moneys of the loans fund as to secure that at the date when the holders of any stock or other security become entitled to claim redemption thereof, moneys sufficient for such redemption are available for the purpose" (Art. 9). It cannot be too strongly emphasised that there has been no departure from the basic principles which have always governed the expenditure of loan moneys by local authorities: sanction of Parliament or of

⁸ The ideal conception of a loans pool appears, however, to be that it should be the medium for the receipt and payment of all money due to or by an authority. As is explained in para. 57, the analysis of cash as between capital and revenue lacks a logical foundation, and the acceptance of this theory of a loans pool would imply that all payments (by the pool), whether on revenue or capital account is immaterial, constitute advances (to the borrowing account(s) concerned). Similarly, all receipts, whether revenue or capital, would, *ipso facto*, be repayments of advances by the accounts concerned to the pool. Further implications of this theory are found where an authority operates only one bank account (for in this case all money transactions, whether revenue or capital, are pooled in fact) and in the references to a unified investment policy (para. 139). While the Model Scheme draws a line of distinction between capital and revenue moneys, it is understood that more than one local authority in Scotland operates a "complete" loans pool on the conception outlined here.

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a Government Department must first be obtained, and the expenditure must be provided out of revenue within a limited number of years. The loans pool merely provides a convenient and economical means of managing the local authority's loan and debt transactions (and also revenue transactions, where a complete loans pool is operated on the conception outlined in the footnote on page 19), enabling those transactions to be recorded with greater clarity, and, as a consequence, simplifying their control, supervision and inspection.

(2) *Reserve, Superannuation, Insurance and Other Funds*

33. Prior to 1922 a local authority required power under Local Act to set up a superannuation or provident fund for the benefit of its employees. There are examples of Local Acts of 1891 (Manchester) and 1893 (St. Helens) which gave the corporations powers to provide by scheme that moneys contributed to the superannuation funds authorised by those Acts should be "invested upon loans to the corporation." In 1911 and later, however, this wide power was restricted, *e.g.*, in the Newcastle-upon-Tyne Corporation Act of that year, to user of the superannuation fund moneys in the exercise of statutory borrowing powers. Subsequently the Act of 1922 (an adoptive Act) substantially followed the Newcastle-upon-Tyne precedent by providing that the moneys forming part of the superannuation fund might be used for the purpose of any statutory borrowing power possessed by the local authority. Under this Act moneys so used must be repaid to the superannuation fund "within the period, by the methods and out of the fund, rate or revenue within, by and out of which a loan raised under the statutory borrowing power would be repayable." The rate of interest payable on moneys so used must be "calculated at a rate per centum per annum to be determined by the local authority and equal as nearly as may be to the rate of interest which would be payable on a loan raised on mortgage under the statutory borrowing power." Similar provisions are contained in the Fire Brigade Pensions Act, 1925, as to the user of moneys of Pensions Funds set up under that Act.

34. Swansea Corporation in 1922 secured wider powers in the Swansea Corporation Act of that year, on similar lines, namely, to use for the purpose of any statutory borrowing power "any moneys forming part of any sinking fund, loans fund, redemption fund, reserve fund, or insurance fund of the corporation . . . and not for the time being required." The conditions as to repayment and interest are similar to those in the Act of 1922, except that the method of repayment is more restrictively defined as "by equal yearly or half-yearly instalments of principal, or of principal and interest combined."

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35. Among the advantages claimed for the "Swansea Clause" of 1922 was that it would "do away with the absurd practice of 'mutual loans' where two authorities lend to each other a similar amount for a similar period at a similar rate of interest. All the trouble and expense of such transactions is avoided, and incidentally a considerable sum will be saved in costs by the new clause" ("Financial Circular," 1922, p. 248). One of the criticisms levelled against the clause (by Mr. Robert Paton, then City Chamberlain of Edinburgh) was concerned with its object in relation to the investment of reserve funds, viz.: "A corporation investing the reserve funds of trading undertakings or for that matter any other accumulated fund is bound to do the best possible for those funds. It is of doubtful advantage to a fund to invest moneys subject to a condition that repayment must commence within six months or at the most a year from the date of the investment. Investments of reserve funds, etc., should be looked at from the standpoint which a trustee would take in the matter" ("Financial Circular," 1922, p. 289).

36. In the Local Act provisions which followed the lines of the Swansea precedent, the foregoing criticism has been met in part, though not in full, by a condition that the local authority shall repay to the "lending fund" (now extended in scope to cover, in addition to funds accumulated for the redemption of debt, reserve, renewal, depreciation, contingent, accident, insurance, superannuation, capital or other similar funds) the moneys so used as and when the same are required for the purposes of the lending fund. In recent clauses no reference is made to any specific method of repayment, but the obligation remains to repay "within the period and by the methods within and by which a loan raised under the statutory borrowing power would be repayable." (See, *e.g.*, the Torquay Corporation Act, 1934, Sec. 106.)

37. It is only where a loans pool has been set up that the greatest possible freedom is permitted in the use of such funds. Where power is obtained by Local Act to set up a loans pool, this is commonly accompanied by the power to pay into the fund any moneys forming part of any reserve, renewals, depreciation, contingent, insurance, superannuation, or other similar fund and not for the time being required; such moneys are to be deemed to be moneys borrowed by the authority, to be used subject to the following conditions:—

(1) The moneys so used must be repaid to the lending fund as and when required for meeting the obligations for which that fund was established; and

(2) Interest must be paid to the lending fund on any moneys so used and for the time being not repaid at such rate per centum per annum as may be determined by the authority to be equal as nearly as may be to the average rate of interest payable by the authority on their current borrowings.

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As will be seen later, considerable variations exist in the interpretation of these conditions, particularly as regards the rate of interest to be allowed.

C.—PRESENT-DAY USE OF LOCAL AUTHORITY FUNDS FOR INTERNAL PURPOSES

(I) *Practice as revealed by a Detailed Inquiry*

38. A preliminary study of the field of inquiry showed that much depended upon the manner in which local authorities conduct their financial operations in regard to borrowing and investment. There are broadly two main classes; firstly, those which centralise all or nearly all their loan and investment transactions in a consolidated fund or account, and secondly, those which appropriate particular transactions to particular funds.

39. Passing over for the moment any statutory limitations, it seems reasonable to argue that a local authority, which is a definite administrative entity, should conduct its borrowing and investment operations as a unit, and the strength of this contention is increased by the fact that the security available to a lender to a local authority is broadly the rates and revenues of the authority. In other words, a local authority requiring money for the purposes of, say, its gas undertaking, borrows as a local authority, and the question of appropriating money for gas purposes only arises after the act of borrowing has been completed. Since the lender's title is against the rates and revenues of the authority, it is clearly inconsistent to earmark the particular sum borrowed to a particular undertaking or account.

40. Relatively few authorities, however, appear to have appreciated the theory of the loans pool. The application of this theory, very briefly, is that a local authority borrows as a unit; that its loans at any particular date form a pool (this is consistent with the lender's security), that actual repayment of loans is made from the pool; and, consequently, that the case for earmarking of sinking funds fails. What takes place under this system is that an undertaking which has incurred loan expenditure repays to the loans pool annually such amounts as will, over the appropriate period of years, liquidate such expenditure. It is once more emphasised that the period for which a loan is raised has no connection whatever with the period sanctioned for redemption of the loan expenditure.

41. In present times, when local bodies are incurring large sums of capital expenditure for housing and other purposes, it is clear that, even after deducting amounts provided for "sinking fund," there is a tendency for local indebtedness to increase, and accordingly, that where a loans pool exists, the sums paid in by borrowing departments

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towards liquidation of their loan expenditures may profitably be employed in meeting new loan expenditure, thus avoiding, to an equal extent, borrowing from the public.

42. It is true that under the old system there was a tendency to accumulate investments in the form of securities, which were available as liquid assets for the actual repayment of loans, and, accordingly, where a loans pool exists, care must be exercised in the administration of the fund, so as to secure that, at the date of maturity of loans, funds are available, or can be raised, to repay lenders.

43. The same argument holds good to a smaller extent in regard to other funds, such as superannuation and reserve funds. Taking a local authority as a whole, the existence of such funds actually constitutes a decrease in the authority's net indebtedness; thus, if such funds are invested in outside securities it follows that a corresponding amount of actual public money has to be borrowed.

44. There is an increasing tendency to adopt the policy of internal user of such funds, and this policy may be advantageous both to the local authority funds concerned and to the local authority as borrower, provided that the terms of such internal user are no less favourable than those which could have been obtained by outside investment, and provided also that funds are available, or can instantly be raised, to meet demands by local authority funds. (NOTE.—A demand by a local authority fund arises where the income of the fund, for the time being, is insufficient to meet the expenditure.) Internal user will also produce some incidental saving in stamp duty, and possibly also in other directions.

45. Pursuing this theory to its conclusion, it seems that if all loans are raised and repaid by the local authority as a unit, then interest is paid in the same way, and the loans pool itself takes the immediate benefit (or suffers the loss) of changes in rates of interest (and it may be argued also that the loans pool must take any profit or bear any loss arising from outside investment transactions). Clearly, in such a case, borrowing departments will pay interest to the loans pool at an average rate. If the local authority had no existing debt, the "average" rate would also be the "current" rate; there is, however, invariably existing debt, and new borrowing departments (which obtain funds on the security of the whole rates and revenues of the authority) can hardly complain if the average rate is sometimes higher than the current rate. On a long view it is likely to be the reverse just as often.⁴

⁴ It should be observed, however, that during periods of low or falling interest rates, the average rate will tend to be higher than the current rate. Conversely, during periods of relatively high or rising interest rates, the average rate will tend to be lower than the current rate.

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46. These points have been mentioned so as to make clear the modern theory of local authority borrowing. It will be seen later that where this theory had been applied, this inquiry was greatly simplified.

47. It may here be remarked also that the purpose of establishing and indeed the justification for the existence of local authority funds is that they are designed to meet future liabilities, which may be:—

- (a) fixed both in amount and time (*e.g.*, stock sinking funds).
- (b) theoretically fixed in amount but not in time (*e.g.*, superannuation funds).
- (c) fixed neither as to amount nor as to time (*e.g.*, general reserve funds).

The factors governing any investment policy—*i.e.*, security, liquidity and yield—are present in varying degrees in each case, and the mere fact of internal user should not affect these considerations, which should be viewed in their relation to the peculiar characteristics of each fund. This is a viewpoint which existing statutory provisions obviously do not fully meet.

48. In order to ascertain the extent to which local authority funds are at present used for internal purposes, a questionnaire was issued in February, 1934, to a representative selection of 60 local authorities in England and Scotland, and the results obtained from the returns completed by 40 local authorities (including the London County Council) are summarised in the Appendix. The figures relating to the London County Council have been excluded from the general tabulations and percentages, since their relative magnitude might have tended to bias the results, and the position of the London County Council is separately dealt with in Section G of this report.

49. Before actually considering the figures obtained, it may be pointed out that the Ministry of Health's Report for 1934-35 shows the gross outstanding loan debt of all local authorities (in England and Wales) at the 31st March, 1933, as £1,393,647,611, and the net loan debt as £1,300,324,337. Special fund balances are shown as follows:—

	£
Sinking and Redemption Funds	93,219,925
Reserve Funds	20,092,489
Insurance Funds	3,735,212
Trust or Charity Funds	2,291,509
Superannuation Funds	42,133,792
Other Special Funds	6,933,806
Total	<u>£168,406,733</u>

or 12.9 per cent. of the total net loan debt.

50. These figures are given so that the extent of the ground covered by the questionnaire can be viewed in its proper perspective. Some-

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thing over one-fourth of the gross debt is included in the tabulations in the Appendix; more than one-third of the amount of the superannuation funds, nearly one-third of the insurance funds, and about one-half of the reserve funds. (The inclusion of certain Scottish figures, of course, biases these broad comparisons to some extent, but not sufficiently to defeat their main purpose.)

51. Table 1 (pages 56-57) shows a gross debt (excluding London County Council debt) of £254,276,000, the distribution in maturity periods being—

Maturing within 5 years from date of return	52.0 per cent.
Maturing after 5 years and before 10 years	
from date of return	9.5 ..
Maturing after 10 years from date of return	38.5 ..

Of the total, 5.5 per cent. has been borrowed from local authority funds.

52. Inspection of individual cases confirms the known tendency for authorities in the southern parts of the country to hold in short-dated loans only a small part of their total loan debt, and also the reverse tendency for northern authorities, particularly in Scotland. The following table illustrates the group distribution:—

Percentage of total debt	Debt maturing within 5 years from date of return	Debt maturing 5-10 years from date of return	Debt maturing after 10 years from date of return
Under 10	4 cases	24 cases	3 cases
10—20	2	12	7
20—30	2	1	2
30—40	4	1	5
40—50	10	1	6
50—60	5	0	10
60—70	2	0	0
70—80	5	0	3
80—90	3	0	2
Over 90	2	0	1
Total	39	39	39

53. It should be pointed out, however, that the broad effect of the persistence of present-day money conditions must be to induce long-dated borrowing operations of all types, including particularly the substitution of loans for relatively long periods in place of shorter date loans. The only evidence available in this connection relates to stock issues, although a large amount of long-term mortgage borrow-

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ing must also have taken place. From 1st January, 1933, to 30th June, 1935, 65 issues of stock have been made by town and county councils, involving a capital of nearly £88 millions. Compulsory redemption periods and amounts may be approximately analysed thus:—

Maturing 20-23 years from date of issue	..	£32½ millions.
„ 25-27 „ „	..	9½ „
„ 29-31 „ „	..	28½ „
„ 35-40 „ „	..	16 „
„ 50 „ „	..	1 „
„ 60 „ „	..	½ „

54. Even bearing in mind that the total net loan debt (England and Wales only) at 31st March, 1933, amounted to £1,300 millions (para. 49), it is clear that the intensity⁵ of the loan liabilities of local authorities has been, and is being, radically reduced. This tendency may be expected to continue so long as cheap money is obtainable for relatively long periods.

55. Table 2 (pages 58-59) discloses an analysis of the loans maturing within five years from the dates of the returns, as follows:—

Stock	..	..	..	..	..	9.0 per cent.
Mortgages, Housing Bonds, etc.	..	..	..	..	..	80.8 „
Temporary Loans	..	..	..	..	..	3.2 „
Local Authority Funds	..	..	..	..	..	7.0 „
						<hr/>
						100.0 „

Comparing this with Table 1, it will be observed that more than 50 per cent. of the local authority funds used are repayable within five years. An endeavour was made to ascertain what real reserves (*i.e.*, funds and investments instantly or readily available) were held against these maturing loans, and (subject to the qualifications set out in paras. 105-120 dealing with real reserves) the percentage of real reserve to debt maturing within five years was found to be 11 (or, very broadly, equal to a sum rather greater than the average debt maturing in one half-year).

56. The information in Table 3—Local Authority Funds used internally (pages 60-61)—must be read subject to note (a) appended to the table. Where loans pools exist, of course, there are no sinking funds to use. In other cases, complications arise, for sinking funds may be used several times during the life of a stock, if the capital expenditures for which they are applied are such as to

⁵ The word “intensity” (which again appears in paras. 76 and 118) is a relative term which is used to denote the degree to which the loan debt of a local authority matures for repayment soon. The greater the proportion of loan debt expiring immediately or at a relatively early date, the greater the intensity of loan liability.

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require liquidation in short periods. The table shows, however, that reserve funds formed 28 per cent. of the local authority funds stated to be used, sinking funds 26.4 per cent., superannuation funds 37 per cent., insurance funds 3.1 per cent., and other funds 5.5 per cent. Besides forming the largest item in the sequence, superannuation funds are used internally in the greatest number of cases.

57. Real reserves, in the form of investments and cash balances, were held to the extent of 11 per cent. of the total of debt maturing within five years (Table 4—pages 62-63). These reserves consisted of:—

Corporation Stocks	6.5 per cent.
Corporation Mortgages	43.3 "
Government Stocks	31.4 "
Treasury Bills, Temporary Loans, Bank and Cash	16.0 "
Other Investments	2.8 "
	100.0 "

As indicated in Note 1 in Table 4, it appears that these reserves are considerably understated, as in some cases, particularly where loans funds do not exist, surplus revenue balances and uninvested balances of local authority funds do not appear to have been included in the figures returned. In many cases, where no reserves are stated, it was evident from the answers to other sections of the questionnaire that reserves did in fact exist. Probably this is due to the distinction commonly drawn in England between what is called "Capital Cash" and "Revenue Cash." While this point is not strictly relevant to the present discussion, except in regard to the ascertainment of what is available as a local authority's real reserve to meet its lenders, it seems clear that this cash analysis, in relation to local authority borrowing and the reserve maintained, has no logic to support it. The fact that an authority describes cash as "Revenue Cash" does not make it any the less available for the payment of capital creditors, while from the book-keeping viewpoint, if the accounting system and balance sheets are properly planned, all necessary analyses may be made from them.

58. The following shows the position as regards the local authority funds (other than sinking funds) concerned:—

	Invested		Not	
	Externally.	Internally.	invested.	Total.
Table 5—Reserve Funds ..	32.3	41.3	26.4	100.0
„ 6—Superannuation Funds ..	33.9	63.5	2.6	100.0
„ 7—Insurance Funds ..	24.9	67.5	7.6	100.0

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There is probably no special significance attaching to these figures. The relatively large amounts of the reserve funds not invested (26.4 per cent. as against 2.6 per cent. in the case of superannuation funds and 7.6 per cent. in the case of insurance funds) may be due to the fact that considerable sums are used as working capital for the undertakings concerned. As regards superannuation funds, these are largely used internally by a number of towns, and no doubt the general power conferred by the Act of 1922 has been a factor contributing to the large percentage of these funds used internally. Two of the largest insurance funds—Nos. 2 and 12, Table 7—are wholly used internally, resulting in perhaps an undue weighting of the percentage.

59. It is not possible to say anything definite as to the rate of development of the practice of internal utilisation, since no comparative data are available. In the replies to three of the questionnaires, however, it is definitely stated that in future local authority funds are to be utilised internally and this, taken together with the gradually increasing number of loans pools, makes it fairly evident that the practice is in fact increasing. (See also paras. 68-72.)

(2) *Terms and Conditions of Internal Investment.*

60. A remarkable variety of arrangements has been found to exist, both as regards interest rates and conditions of repayment. Out of the 40 replies received, a settled policy was said to have been adopted in 24 cases, either no definite policy existing or no answer being given in the remainder. Fourteen authorities use all their funds internally; only two use no funds at all, and the remainder pursue a middle course. As will be seen from the tables, however, in a number of these remaining cases, most of the funds are used internally. There are two cases in which no local authority funds are used internally except superannuation funds. One local authority uses broadly 50 per cent. of its superannuation fund internally, the remainder being invested outside, on the reasoning (which is not easy to follow) that the contributions by employer and employees should be separately dealt with.

61. The following are among the arrangements stated to exist as regards interest rates:—

1. Rate offered for Mortgage loans (Note 1)—
 - (a) reviewed annually,
 - (b) reviewed half-yearly,
 - (c) reviewed periodically, as required;
2. Average rate paid by loans pool;
3. Yield on Government securities at date of investment (Note 2);

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4. Average rate payable on current borrowings during preceding six months;
5. Prevailing rate;
6. Rate earned if invested outside;
7. Overdraft rate;
8. Public Works Loan Commissioners rate; and
9. Estimated stock issue rate—fixed for advances made each year.

Note (1).—In the case of Metropolitan borough councils, the rate requires the approval of the Minister of Health.

Note (2).—There was only one case in which this arrangement was stated to exist, and the reply to the questionnaire did not indicate any particular type of Government security.

62. Without examining all these variations in detail, it is evident that the information is incomplete, nothing being said about period of loan (*e.g.*, a 20-year mortgage will at the moment carry a higher rate than one for 5 years). The most common rate, however, was $3\frac{1}{2}$ per cent., with downward variations to $3\frac{1}{4}$ per cent. (and 3 per cent. in one case), and upward variations to $3\frac{3}{4}$ per cent., 4 per cent., and in one case $4\frac{1}{2}$ per cent. In one case, at least, a preference of one-half per cent. was allowed to investments of the superannuation fund, these being deemed to be long-term investments.

63. Mr. A. Carson Roberts, on page 167 of his textbook, "Local Administration—Finance and Accounts," makes the following suggestions as to regulating the rate of interest for such investments:—

"(1) Such rate as is offered on behalf of the loans fund, and accepted by the committee by which the lending fund is controlled.

"(2) The above rate, subject to revision by agreement at the end of (say) each five years, or repayment of the loan where agreement cannot be reached.

"(3) The above rate, subject to variation on a line parallel to the variation in the average rate of interest paid by the authority on other loans.

"It would appear to be necessary to guard against any case arising in which the committee managing the lending fund is forced to invest in this way (*i.e.*, internally)."

At this stage the dictum of Mr. Robert Paton (already quoted in para. 35) may again be referred to—"a corporation investing the reserve funds of trading undertakings or for that matter any other accumulated fund is bound to do the best possible for these funds . . . Investments of reserve funds, etc., should be looked at from the standpoint which a trustee would take in the matter."

64. As regards repayment, the following are among the arrangements:—

1. At call.
2. Partly at call and partly at fixed dates.
3. Annual repayments of principal.

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4. Annuities (principal and interest).

5. Same as for mortgage loans—*i.e.*, fixed dates, or fixed dates with six months' notice thereafter.

Repayment at call predominates, occurring in 18 cases, and repayment at fixed dates is the next most popular method.

65. The terms of investment show little regard generally for the relation which should exist between interest rates and maturity dates, and while a large proportion of loans is at call yet long-term or at least medium-term (5-10 years) interest rates are allowed.

66. This arrangement, generally speaking, is not likely to prejudice the lending funds, particularly in the cases of reserve funds and insurance funds. In the case of superannuation funds, however, it may be open to doubt whether a higher yield could not have been earned in outside long-term securities, and in this connection probably interest arrangements Nos. 8 and 9 (para. 61) are most satisfactory. There remains the important point as to whether the undertaking to repay at call could in fact be implemented. This involves a consideration of the liquid assets in the hands of, or available to, the authorities concerned, a matter fully discussed in paras. 105-120.

67. Clearly, however, there is a lack of uniformity in the terms and conditions upon which local authority funds are used internally. This may be, and probably is, due to two causes: (a) the indefinite wording of the statutory enactments dealing with the point; and (b) confusion of thought on the part of the authorities concerned, who may have failed to recognise the two conflicting sets of interests involved, and the necessity for holding the balance evenly between them. It is suggested that the following conditions should govern the internal user of local authority funds:—

(1) User should be permissive, and not obligatory, in respect of all local authority funds. This would leave to the local authority the alternatives of adopting either a unified investment policy through the agency of the loans pool or a direct investment policy for each fund.

(2) Internal loans should be made for periods appropriate to the needs of the lending funds. This would enable investments to be so arranged as to secure not only a suitable flow of maturities, but also an adequate proportion of investments realisable at call.

(3) Interest on internal loans should be paid to the lending fund at a rate or rates equivalent to the greater of—

(a) the rate at which the local authority could at the date of such loans borrow from outside sources for corresponding periods; or

(b) the rate at which the local authority fund concerned could, at the date of such loans, invest in outside securities of comparable status, for corresponding periods.

(Where (a) and (b) are equal, there is no point in the alternatives suggested. Where (a) exceeds (b), internal use benefits both the local authority as a borrower and the fund as a lender. Where, however, (b) exceeds (a) (and

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this may be a not unlikely contingency in larger authorities) either of two things will happen. Either the local authority fund will invest directly in outside securities at rate (b), or it will invest with the loans pool at rate (b) and an equivalent amount may be invested outside by the pool at the same rate. Money required by the loans fund may meanwhile be borrowed at rate (a), *i.e.*, the lower rate. The avoidance of speculation with borrowed money is briefly touched upon in para. 114, but such an arrangement as is contemplated here can hardly be classed as speculation, for its only object is adequately to recognise the two sets of interests affected, *i.e.*, those of the local authority as a borrower and those of the local authority as trustee for the lending funds.)

(3) Some Observations on the Future Growth of Local Authority Funds

68. Evidences of the growing magnitude of local authority fund balances available for investment or use are not difficult to find. The increasing activities of local authorities will extend the necessity for adequate reserve funds, and while the Electricity (Supply) Acts, which limit electricity reserve funds to an amount equal to 10 per cent. of the aggregate capital expenditure, may, to some extent, check undue expansion, yet housing repairs funds are likely to increase in amount, and there is also the present-day tendency to establish capital reserve and equalisation funds in connection with rate funds.

69. The extension of the loan-pooling system will ultimately remove altogether the question of sinking and redemption fund earmarking and investment, but there is nevertheless the prospect of increasing contributions from rates and revenues to redeem capital expenditure. Where these contributions exceed new capital expenditure there will be a surplus available for investment or for repayment of external loans.

70. Superannuation funds present an even larger problem. Firstly, the increasing tendency to adopt superannuation schemes is obviously bound to add to the volume of the investment problem, and secondly, the basic principle of an actuarially calculated scheme is to provide, by contribution and accumulation, for a future pension liability. As it is only 13 years since the Act of 1922 was passed, increasing superannuation fund balances must follow as a matter of course. Moreover, one cannot ignore the possibility that superannuation for local government officers may be made compulsory by statute, instead of a discretion being left with individual local authorities, as at present.

71. Similarly to all the above, the balances on insurance funds may be expected substantially to increase, partly owing to the establishment of new funds, and partly owing to the expansion of existing funds.

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72. Reviewing the whole situation it may reasonably be inferred that a continuing increase will take place in the amount of local authority funds available. This will have two important consequences, both of which are somewhat dependent upon the tendency of net local indebtedness to increase or diminish. The future course of indebtedness is difficult to foresee: while there is probably a present tendency for it to increase, it is not unlikely, on a long view, that it may gradually diminish. If net local indebtedness remains more or less stationary, local authority funds will form an increasingly greater proportion of local debt than they do now, and to that extent outside borrowing will be reduced. It may be that in some cases the amounts available each year in the form of "sinking fund" contributions, contributions and accretions to reserve funds and superannuation funds, etc., will be sufficient to finance the year's programme of capital expenditure, and in this event external borrowing transactions will be limited to repayment of loans and conversion operations. In fact, there must in general be a growing tendency in this direction. A continuous fall in the curve of yearly capital expenditure might, on a very long view, produce a condition in which the whole debt of a local authority would consist of internal loans from local authority funds. But, however these tendencies may develop, there can be no doubt that local authority funds will play an increasingly important part in the economy of local debt, and the second important consequence is, clearly, that an expansion in local authority funds available will call for an increased measure of care and skill in investment and an increased regard for the point of view of the funds concerned.

D.—SPECIAL CONSIDERATIONS RELATING TO THE INTERNAL USE OF SINKING FUNDS

(I) *General*

73. Does the constitution and existence of these funds involve the title of lenders to claim repayment at maturity dates? Parliament has recognised the use of sinking funds for capital purposes as well as the ultimate development of the loans pool, under which broadly any excess of (A) new capital expenditure incurred over (B) capital expenditure provided from revenue, requires to be borrowed (either internally from local authority funds, or externally), and any excess of (B) over (A) is available as liquid assets in the hands of the authority concerned. The title of the lender is against (a) in England, "the revenues of the authority" ("Revenues" are defined by Sec. 218, Local Government Act, 1933, as follows: "in relation to a local authority, includes the county fund or general rate fund, as the case may be, and all rates, exchequer contributions and other revenues whether arising from land or undertakings or from any other

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source receivable by the local authority "); (b) in Scotland, " all funds, rates and revenues of the council " (Sec. 23, Local Government (Scotland) Act, 1929).

74. Thus the position of a lender is not influenced in the least degree by the existence or otherwise of a sinking fund. His rights are laid down by law and he is concerned only to see that the affairs of the authority are so administered as to secure that funds are available to repay his loan when due. This key factor is recognised by the Model Scheme, Art. 9, which has already been quoted in para. 32, viz., that " the authority shall so administer the capital moneys of the loans fund as to secure that at the date when the holders of any stock or other security become entitled to claim redemption thereof moneys sufficient for such redemption are available for the purpose."

75. It seems to be a moot point whether the word " capital " should not be deleted from Article 9 of the Model Scheme, in view of the general nature of the lender's security, which recognises no distinctions of book-keeping as between capital and revenue (see also para. 57).

76. From the foregoing it may be reasonably inferred that the term " sinking fund," at least in its application to local finance, is something of a misnomer. The real necessity is not the creation of a sinking fund, but the careful planning of rating and trading budgets in order to provide adequate funds for liquidating capital expenditure. The disposal of the funds so created (*e.g.*, in internal or external investment or in loan repayment) is a matter depending chiefly upon the intensity of the local authority's loan liabilities and existing rates of interest.

(2) Stock Sinking Funds

77. Provision was made in the questionnaire for obtaining certain special information in regard to stock issues, particularly as to past maturities of stock. Local authorities were asked whether any of their stocks had matured during the last 20 years, and, if so, how the necessary capital was provided for their repayment. In two cases (both stated to be small) the money was available in the sinking funds. In ten other cases, resort was had to stock conversions, substitution of mortgages for stock, new mortgages, and, of course, use of sinking funds, where available and necessary.

78. A question was also asked, in regard to the use of stock sinking funds internally (*i.e.*, where no loans pool exists) whether the terms of user provided for repayment before the maturity dates of the stocks concerned. The replies were divided almost equally into negatives and affirmatives.

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79. This point need not be further laboured here, since, in the case of the early post-war stock issues in particular, it is a known fact (see para. 26) that a stock sinking fund, based on the period of years allowed for writing off the capital expenditure concerned, would be absolutely inadequate to repay the stockholders at stock maturity date. Accordingly it is of little or no importance whether or no the terms of use of such funds provide for repayment before any specified date.

80. So far as impending maturities were concerned it was naturally impossible to obtain exact information. In most cases, however, conversion or reborrowing was contemplated.

81. It must be constantly borne in mind that if no undertaking to establish funds *exclusively applicable* to purchase of stock has been given, the name "stock sinking fund" has internal significance only, and is of no importance to the lender, who is concerned only with the existence of sufficient liquid assets to repay his claim at maturity date, if he wishes to enforce it. The facts of the case, so far as past maturities in this review are concerned, are that either the so-called sinking funds were insufficient or the claims were not enforced.

82. It may be emphasised that (apart from the application of the proceeds of sale of assets or other special capital receipts) no effective reduction of loan debt is possible except where the annual sums provided from revenue towards liquidation of capital expenditure exceed the amounts applied each year in new capital expenditure. Unless, therefore, an adequate margin of funds provided in this way is available, repayment of a stock at maturity of necessity involves replacement by fresh borrowing in one form or another.

83. Generally, therefore, it is seen that over a long period there is, in local authority loans administration, a continued substitution of one set of loan holders for another. Thus the total loan debt of an authority will at any one date be owing to one set of creditors (under certain conditions as to interest, maturity, etc.), and there will be a steady flow of changes in the personnel and nature of these creditors. As an offset to this loan debt there is a set of constantly changing assets, the cost of which is being regularly liquidated out of rates and other revenues, and the real criterion of the security of a local authority is to be found, not in any undertaking to repay a lender or group of lenders on any definite date, but in its obligation annually to provide adequate contributions out of such rates and other revenues in liquidation of capital expenditure. Stock maturity dates are, therefore, significant to a local authority only in so far as they necessitate the carrying out of conversion or substitutional loan

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operations, and it is only when stocks mature during periods of relatively cheap money that this is of advantage to the local authority.

84. From this it may be argued that the present maximum life allowed by statute for stock (*i.e.*, 60 years) should be abolished, and that there should be no bar to the creation and issue of stock for such periods and on such terms as may be obtainable. This amounts to no more than a suggestion that a method of borrowing used by the Central Government⁶ should be made available to local authorities. In such a position the real meaning of the term "sinking fund" would be quite clear, for it would then connote nothing else than the provision made annually from rates and revenues to liquidate capital expenditure.

(3) The Stock Prospectus

85. In view of the importance of the stock prospectus as constituting the basis for subscription of very large sums, certain special inquiries were made, particularly in regard to what may be called the redemption clause of the prospectus. A representative selection of prospectuses has been gathered, and where actual copies were not available, the questionnaire provided for an indication being given of the contents of the redemption clause.

86. In certain issues in 1920 the following clause appeared:—

"The Ministry of Health requires the Council to make annual provision for the ultimate redemption of their stocks by means of a sinking fund and to furnish annual returns showing the position of their loans account."

Issues in 1928 and 1931 contained similar clauses, while in 1926 and subsequently, slight variations have been introduced, providing "for the formation of a sinking fund for the repayment of the loans raised by the stock" and "for the redemption of the loans raised by this stock . . . by the creation of sinking funds." There may be observed particularly the reference to "sinking funds" which still persists in the majority of prospectuses issued at the present time, *e.g.*, Stockton-on-Tees (1934), Bexhill (1935), Stoke-on-Trent (1934), Birmingham (1934), Wakefield (1935), Birkenhead (1935) and Cardiff (1935). Though not definitely stated it seems a fair inference that the sinking fund is expected to be sufficient to redeem the stock. The London County Council prospectuses of 1930 and 1935 both provide "for a sinking fund sufficient to redeem all consolidated stock within the period prescribed by Parliament." It is true that

⁶ Cf., 3 per cent. Local Loans Stock, redeemable 1912 or after; 3½ per cent. Conversion Stock, redeemable 1961 or after; 3½ per cent. War Loan, redeemable 1952 or after; 4 per cent. Consols, redeemable 1957 or after; also India 3 per cent. Stock, redeemable 1948 or after; and India 3½ per cent. Stock, redeemable 1931 or after.

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this may not (and probably does not) import a definite obligation to apply sinking funds in purchasing stock, but there is undoubtedly a certain ambiguity which might at least give rise to misunderstanding.

87. The first English prospectus which omits the reference to a sinking fund appears to be that of Sheffield (1933)—

“ The Acts of Parliament and Orders under which the Corporation is authorised to borrow the money provide for the redemption of the debt created by this issue, and require that returns in connection therewith shall be made to the Ministry of Health.”

A loans pool is operated in Sheffield, and the relative scheme includes a provision identical with Article 9 of the Model Scheme, which has already been quoted. (Paras. 32 and 74.)

88. Coventry (1934) went a step further by actually incorporating in the prospectus a specific reference to the loans pool—the clause may be quoted:—

“ Provision for the redemption of the debt created by this issue of stock will be made in accordance with the Corporation's Consolidated Loans Fund Scheme, which was set up under statutory authority and with the approval of the Minister of Health in 1930; the Scheme requires that annual accounts and returns in connection therewith shall be made to the Minister of Health.”

89. Further modern variations occur in the following cases:—

Colwyn Bay (1935)

“ Provision for the repayment of the loans raised by this stock will be made by repayment to the Consolidated Loans Fund (Colwyn Bay) Scheme, 1932, as required by the Acts of Parliament. . . . ”

Leeds (1935)

“ The Corporation is required by Acts of Parliament and by the Consolidated Loans Fund (Leeds) Scheme, 1927, to make annual provision towards the redemption of its stock, and to furnish to the Minister of Health, when required by him so to do, returns showing the provision made for such redemption.”

Liverpool (1935)

“ The liquidation of the several debts of the Corporation is being provided for by redemption funds or sinking funds, in accordance with the several Acts or sanctions relating thereto, and the amount standing to the credit of such funds on the 31st March, 1935, was ”

The last of these prospectuses (Liverpool) retains the reference to “ sinking funds,” although, in an earlier paragraph, the prospectus states that “ the stock is secured upon the whole of the rates and revenues of the Corporation and ranks *pari passu* with all stock issued by the Corporation.” In none of the cases is any reference made to re-borrowing.

90. Scottish prospectuses have been framed on lines similar to modern English prospectuses. Edinburgh prospectuses (1924 and

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1926) indicate that the Corporation are required "by their Acts of Parliament to make annual provision for the redemption of all debt created or to be created by them under these Acts." Dundee (1933 and 1935), Kirkcaldy (1934) and Aberdeen (1935) prospectuses require the respective corporations "to make annual provision towards redemption of all loans for capital expenditure, and annually to furnish the Secretary of State for Scotland with duly certified audited accounts." Returning to English forms, however, Nottingham (1935) is in similar terms as to annual provision for ultimate redemption, and Manchester (1935) follows broadly the same lines.

91. There is a subtle difference between English and Scottish "redemption clauses," to which further reference will later be made. Later English forms simply refer to the efficient administration of the loans pool (and there is no direct reference or implication in the prospectuses as to ultimate provision of capital expenditure out of revenue).

92. The position may be summed up in the following manner. The older form of the "redemption clause" provides for the creation or formation of a sinking fund; the inconsistency and illogicality of this requirement have already been fully discussed. Later English forms provide for redemption of the debt created by the stock in accordance with the authority's consolidated loans fund scheme. The method by which such funds are to be provided is not specified, but conversion or re-borrowing, as has already been stated, is usual (although the terms of the prospectuses hardly imply it). Nothing is said about adequate provision from rates or revenues to write off capital expenditure (although, of course, Articles 4 (1) (D) and 14 of the Model Scheme provide for annual contributions from revenues). The Scottish forms, however, indicate more clearly the local authority's obligation so to frame its rating and trading budgets as to provide funds for writing off capital expenditure. It is here that the vital question arises and suggestions are made in the following paragraphs as to the adoption of a standard form of "redemption clause," relating clearly the security given to the lender with the obligation to levy sufficient rates and charges to make the security operative. (It is only fair, however, to say that the Sheffield prospectus of 1933, already quoted, is free, owing to the general nature of its terms, from ambiguity or misinterpretation.)

93. Where a loans pool exists, and stock is issued, it is highly desirable that the terms of the stock prospectus should be explicit and not capable of ambiguity. It should be made clear that there will be no "attached" sinking or redemption fund to support the stock

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and that the obligation to redeem the stock at maturity is one that will be met in terms of the consolidated loans fund scheme. Since, broadly speaking, all stocks carry the same security, there seems every reason to advocate uniformity in the terms of prospectuses. The vital points are, firstly, that the authority is bound to levy sufficient rates and charges to liquidate its loan expenditure within stated periods, and secondly, that the stock will be dealt with at maturity as required by the authority's statutory obligations.

94. The following are suggested as alternative clauses which might usefully be adopted as being free from possibilities of misconception:—

(1) The Acts of Parliament and Orders under which the Corporation are authorised to borrow the money provide for the redemption of the debt created by this issue, and require that returns in connection therewith shall be made to the Ministry of Health. (Sheffield, 1933.)

(But note—an issue of stock *ipso facto* does not necessarily create effective debt.)

(2) The Corporation are required by law—

- (i) to secure that at the date of repayment of this stock, moneys sufficient for repayment are available, and such moneys may be provided, in whole or in part, by re-borrowing;
- (ii) annually to make adequate provision out of their rates and revenues towards the liquidation of expenditure authorised to be defrayed from borrowed money;
- (iii) annually to furnish to the Ministry of Health returns showing the position in regard to their capital debt; and
- (iv) to submit their accounts for audit by a professional (or Government) auditor.

The second form, which is suitable only where a loans pool exists, focuses attention on the salient points, *i.e.*, (1) that expenditure met from loans must ultimately be defrayed from rates or revenues, and (2) that re-borrowing or conversion may be resorted to for the purpose of meeting expiring loans. It also emphasises the outside control which is exercised over the finances of local authorities.

(4) *Safeguards against Abuse*

95. The true significance of redemption and sinking funds in local authority finance does not seem to be understood outside municipal circles, and from time to time criticism is directed to what is considered to be a misuse of such funds. Thus, the City Editor of *The Times* in 1929 strongly criticised the practice of utilising sinking fund moneys for new capital purposes. After stating that “municipalities . . . make such strange uses of sinking funds created for the redemption of debt that the conclusion seems irresistible that financial principles are not too well understood by these bodies,” he pointed

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out that "in the case of private companies and corporations the sinking funds accumulate in the hands of an independent trustee, who invests the money in a very liquid form pending its use in the purchase and cancellation of stock for whose redemption it was created," and he finally expressed the view that "if not used in the purchase of the appropriate stock, sinking funds should be kept as a bank deposit, if a satisfactory rate of interest can be secured, or invested in a very liquid form of security which is not the debt of the borrower." These remarks provoked the reply that the Select Committee had reported in 1909 that the practice of using sinking fund moneys for new capital purposes was, *if properly safeguarded*, financially unobjectionable. In this connection it may be useful to inquire as to the "proper safeguards" which exist in a consolidated loans fund scheme. There is first of all the obligation imposed by Art .9, already quoted and requoted here, that "the authority shall so administer the capital moneys of the loans fund as to secure that at the date when the holders of any stock or other security become entitled to claim redemption thereof moneys sufficient for such redemption are available for the purpose"; then the scheme permits the holding of investments to a very large amount (although certain criticisms in this connection are made in para. 117) (Art. 8 (2)); there is provision for a careful audit of the transactions of the fund; and finally a certified abstract and statistical statement of all transactions must be furnished annually to the Minister of Health.

96. A safeguard which may perhaps be specially emphasised is that relating to Parliamentary control of expenditure proposed to be defrayed out of borrowed money. In England and Wales, Government sanction is commonly required before borrowing takes place; this is partly true in Scotland, where there is also a provision that sanction of the appropriate central department must be obtained to borrowing for the purpose of meeting capital expenditure, except where the resolution to borrow is approved by a majority of two-thirds or more of the members of the council present and voting. It seems appropriate to suggest, however, that State supervision might be primarily directed not to control of borrowing, but to actual control of capital expenditure financed by borrowed moneys, and the periods within which it is to be liquidated.⁷ This may be thought to be a distinction without a difference, but it would give added point to the requirement annually to provide adequate sums out of rates and

⁷ In this connection it may be noted that the terms of the authority conferred on the London County Council by their annual Money Act provide that "*The Council may expend on capital account*" for named purposes "such money as they may from time to time think fit not exceeding" a named sum or sums, "and may borrow or otherwise provide for those purposes in accordance with the provisions of the London County Council (Finance Consolidation) Act, 1912" (which prescribes the methods of borrowing available to the London County Council).

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revenues towards the liquidation of expenditure defrayed from borrowed money, which, as has been seen (para. 83), is the real criterion of the security of a local authority.

97. The safeguards described above appear to be adequate; the only matter in regard to which practice varies is the maintenance of a real reserve. It may be pointed out, however, that the fewer the difficulties placed in the way of a local authority raising capital, the less is the need for the maintenance of a real reserve in the form of outside investments. In this connection reference is made to the Report of the Committee on Local Expenditure (Scotland), issued in 1932 (Cmd. 4201), in para. 294 of which the Committee consider that the privilege of being able to raise money by discounting promissory notes should be available to all (Scottish) counties, cities and large burghs. Similarly, in 1929, Mr. Reginald McKenna, in addressing the Institute of Municipal Treasurers and Accountants (Annual Report, page 308), advocated "a cautious extension on a more general basis of the power to effect temporary borrowing by the issue of bills." Mr. McKenna foresaw advantages not only to local authorities, but also to the banks and business undertakings. It is fair to add that the suggestion to extend the power to borrow related only to "the larger authorities." Subject to the foregoing there appear to be adequate safeguards implied in the establishment and administration of a loans pool so far as lenders are concerned, and local authority funds are really in the same position as all other lenders in regard to security of capital. In addition, of course, rating and trading budgets must provide annually adequate funds for writing off capital expenditure.

E.—SPECIAL CONSIDERATIONS RELATING TO THE INTERNAL USE OF RESERVE, SUPERANNUATION, INSURANCE AND OTHER FUNDS

98. *Reserve Funds*.—The main reserves dealt with are those connected with the trading undertakings of local authorities, capital funds, capital reserve funds, the repairs funds established under their housing schemes, and general repairs and renewals funds set up under the authority of Local Act powers. Security and reasonable liquidity are required here, and if it could be proved that these were better obtained by external investment, the case for internal utilisation would be destroyed. The figures obtained show, however, that a relatively large proportion—26.4 per cent.—of the reserve funds dealt with were retained uninvested in the hands of the authorities concerned. It is not known what rate of interest, if any, is allowed on sums so retained, but it is clear that there should be a minimum yield, on the theory that all money can be remuneratively employed, even if at call. If the sums concerned are retained in the same accounts (*e.g.*, electricity) then the point is obviously not material

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(for a transfer of interest can and should be made from revenue to the credit of reserve fund). Otherwise there is a possible injustice to the fund.

99. *Superannuation Funds*.—Such funds have a peculiar trust character: the rights of prospective pensioners and contributors must always be kept in view here, and the investment policy should be directed towards securing the highest yield, consistent with safety, and realisability so far as estimated to be necessary in terms of the actuarial survey every five years. Bearing in mind the provisions of the Act of 1922 as to the quinquennial revaluation of superannuation funds and possible readjustment of rates of contribution, it is clear that local authorities must carefully consider the investment of their superannuation funds. It also seems clear that, granted favourable investment conditions, in the early and intermediate years of a pension fund a long-term investment policy could be pursued, with consequent gains in interest. Liquidity is not a vital factor, yet a considerable proportion of internal loans is held at call (see also para. 112).

100. *Insurance Funds*.—Although the average uninvested balance of 7.6 per cent. appears low, it must be remembered that revenue normally sufficient to meet claims is annually accruing to such funds, and to that extent the apparent need for instant liquidity may be qualified.

101. *General*.—So far, in this section, the investment policy of each fund has been separately considered, but there seems to be no particular reason why there should be a separate *outside* investment policy for each fund. Where the peculiar characteristics and requirements of each type of local authority fund are fairly treated in arranging the terms upon which these funds are used internally, local authority funds assume the same position in relation to the loans fund as outside lenders, and if regard is had to the terms of Article 9 of the Model Scheme it seems reasonable to conclude that a unified investment policy (framed with regard to all the loan liabilities of the authority) could with advantage be adopted.

102. Following the reasoning which supports the institution of a loans pool it is suggested that so far as each fund is concerned an investment policy could be adopted as between it and the loans pool, and a unified "outside" investment policy pursued by the latter. In other words, all local authority funds would in such circumstances become ordinary lenders to the "pool" (choosing the type of investment best suited to the needs of the fund) and the loans pool would have regard to the requirement that liquid assets must be available to meet the claims of maturing loan-holders (including local authority funds).

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103. In the great majority of cases no security is issued when local authority funds are used internally. (Reference is made in several cases to entry in the mortgage register; it is natural, however, to expect some ledger record, apart from the question of issuing actual deeds.) Three cases (two of which are Scottish) issue stamped securities, and in one case deposit receipts under seal and bearing 2d. stamps are given. One further case issues securities only on those loans coming within the scope of district audit, and another authority gives formal receipts. Except in three other instances where interim receipts are granted, all the other replies were definitely in the negative.

104. If local authority funds are to be treated in the same way as external lenders it would seem consistent for some form of security to be granted. A simple acknowledgment, which would not attract *ad valorem* stamp duty, would appear normally to meet the case.

F.—INVESTMENT RESERVES—THE DEBATABLE NEED FOR A “ REAL RESERVE ”

105. The term “ real reserve ” is used to denote the funds possessed by or available to a local authority for the purpose of meeting calls by lenders. In practice, local authority funds, where these are utilised internally, are in the position of ordinary lenders, and are entitled to the same security. Real reserves fall naturally into two classes:—

(a) existing reserves—*e.g.*, investments in Government Stocks, other local authority stocks, other local authority mortgages, Treasury Bills, temporary loans, other investments and bank balances.

(b) potential reserves—*e.g.*, the general power to re-borrow for the purpose of repaying loans, particularly by bank overdraft, and (where it exists) the power to issue bills and promissory notes.

106. It seems clear that these are the only sources available, but this inquiry has revealed that two schools of thought exist; the first treating (b) as a sufficient reserve, and the second aiming at a reasonable actual reserve in addition to the power to re-borrow. (It may be pointed out that the term “ reasonable ” may be varyingly interpreted according to circumstances—such as impending loan maturities, contemplated capital expenditure, changes in rates of interest, and so on—and that an authority maintaining a large real reserve at one date may not find it expedient to do so at another.)

107. Before any figures are given, one or two special points may be mentioned. In regard to the arbitrary distinction between capital and revenue (which has no meaning when considered in relation to the position of lenders), it has already been stated that in a number

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of cases revenue surpluses form an additional reserve not indicated in the replies to the questionnaire.

108. Secondly, a large proportion (43.3 per cent.) of the total reserves stated consists of mortgages of other local authorities. The inclusion of such mortgages as "reserves" may seem open to some criticism, principally on the ground that, since such mortgages are not immediately realisable, they cannot adequately fulfil the purpose intended—that is, of creating a readily realisable reserve. There are several answers to this criticism. Firstly, the financial crisis of 1931-32 revealed that local authority mortgages are a good reserve from the point of view of the authority holding them, in the sense that at maturity date they were realisable without depreciation. Secondly, mortgage investments may intentionally be arranged so as to mature simultaneously (or nearly so) with the expiry of a stock, or, alternatively, a reasonable element of liquidity may be imparted by judicious "staggering" of investments (*i.e.*, by so arranging investments as to obtain a steady flow of maturities). Again, such mortgage holdings would form a first-class security for raising bank loans. Thus, in the sense that they are not subject to fluctuations in capital values, mortgages form a sound reserve, while liquidity may be secured by conscious direction of the investment policy or by raising bank loans on the security of the deposited mortgages.

109. In a considerable number of cases no indication was given as to whether or no a real reserve existed. In four cases it was definitely indicated that no reserve was maintained, reliance being entirely placed upon the power to re-borrow. Twenty-two cases quoted exact figures, and subject to the qualifications already mentioned (para. 57) the following figures emerge. Expressed as percentages of gross outstanding debt, the reserves are classified thus:—

Less than 5 per cent.	..	..	..	..	..	5
5-6 per cent.	..	..	..	..	..	2
6-7 ..	..	..	..	..	..	4
7-8 ..	..	..	..	..	..	2
8-9 ..	..	..	..	..	..	2
9-10 ..	..	..	..	..	..	2
10-11 ..	..	..	..	..	..	None
11-12 ..	..	..	..	..	..	None
12-13 ..	..	..	..	..	..	2
13-14 ..	..	..	..	..	..	None
14-15 ..	..	..	..	..	..	2
15-16 ..	..	..	..	..	..	None
Over 16 ..	..	..	..	..	..	1 (16.1)

In the largest cases, with two important exceptions, large holdings of outside local authority mortgages were included in the real reserves.

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110. It was realised that the necessity for a reserve depends largely upon the degree of liquidity of a local authority's loans and that the shorter the period to maturity date of large blocks of loans (*i.e.*, stocks) the greater the need for the availability of adequate funds. Further examination revealed the fact that in the 11 cases where stock issues mature within five years (from dates of returns), three authorities held reserves greater in amount than the stock outstanding, while in the other cases all except two held reserves of substantial amount. Again, as regards the use of local authority funds, it was found that of the eleven cases where the total of such funds used exceeded £400,000, in six cases the reserves held were nearly equal to or greater than the amount of local authority funds used. In one case the reserves were less, in one case no reserve was maintained, and in the remaining three cases no reserve was stated. It is obvious, of course, that the reserve would only be available once and could not be used at the same time to repay both stockholders and local authority funds.

111. As has already been indicated, there are two schools of thought in regard to the need for maintaining a reserve. The Treasurer of one large English city advanced certain views on the question of holding outside investments, which may briefly be summarised as follows:—

“ If market conditions are good for selling investments the same favourable conditions would make it easy to carry out a conversion scheme—and one would be tempted to do so in order that the investors would not be disturbed by a forced repayment. The reverse applies just as forcibly, inasmuch that if the prevailing conditions were against a favourable conversion operation we should hesitate to have recourse to the investments because of their depressed market price.”

112. The special requirements of superannuation funds have also some bearing upon the nature and extent of any real reserve which may be desirable. If a reserve is to be readily realisable, there will be either or both of two conditions, *i.e.*, relatively low yield, and risk of capital depreciation. Generally, however, a superannuation fund is concerned in obtaining security of capital with as high a yield as possible. Long term mortgages of other local authorities may thus be eminently suitable for investments of superannuation funds, although, as has been shown, the same security and yield may be obtained by internal use on fair terms and conditions.

113. Reference may also be made to pages 138-140 of “ Local Administration—Finance and Accounts ” (A. Carson Roberts), dealing with the desirability or otherwise of holding investments against loans. The proposition is there laid down that special reason must exist to justify a local authority increasing its loan debt in order to

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hold investments. The possibility of financial gain is not included as a special reason, but temporary investment is held to be a desirable thing, as, for example, "wherever capital money, which would otherwise be applied in loan repayment, will before long be needed for other capital purposes, or to ease a stock redemption."

114. While it is true that considerations of gain should not dictate a policy which aims at increasing loans in order to hold investments, yet the term "gain" must be taken, it is suggested, in a relative sense. It could hardly be contended, for instance, that an authority should, as a matter of principle, refrain from investing surplus money, when by so refraining a loss would be sustained.

115. There is also the fact, illogical though it may seem, that the credit of one authority is not the same as that of another, and accordingly that it may pay a large authority to increase its gross debt so as to obtain funds which it may lend to a smaller or less fortunately placed authority. Two authorities at least, the London County Council and the City of Edinburgh, are known to possess statutory powers in this connection. In the case of Edinburgh, the power to lend extends to "any adjoining local authorities"; while the London County Council has power to lend to the metropolitan borough councils, and does in fact advance the bulk of the loans of those bodies. In this connection, also, a further reference may be made to "Local Administration—Finance and Accounts," on page 127 of which it is forecast that "in course of time authority will probably be given to the county councils to raise the loans required by the minor authorities in their areas; and direct borrowing will for the most part be confined to the major local authorities, *i.e.*, those of the counties and county boroughs." Other points affecting the rate of interest at which money can from time to time be raised include industrial conditions as existing in particular areas, and the relative standards of local financial management, but these matters cannot be examined here.

116. Reference may also be made to the terms of Art. 12 (2) of the Model Scheme, which is so framed as to permit of investments being held to a very large amount. Quoting once again from "Local Administration—Finance and Accounts," page 168, "It is possible to imagine a case in which the outstanding loan debt has been doubled in order to increase the amount of investments held." It may be noted that the Model Scheme itself has not extended this power to borrow for investment purposes; "the extent to which investments [*i.e.*, sinking fund investments] can be held against loans has always been immense."

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117. It may be argued that such an extensive power to raise loans for purposes of investment is open to criticism. If this is so, a limit for the loan debt of any authority might be fixed at a sum equal to the authorised borrowing powers (*i.e.*, unexercised borrowing powers, plus borrowing powers exercised less repayments thereon) for capital expenditure *plus* a certain margin for temporary or working capital. Such a requirement would be consistent with the suggestion in para. 96 as to Government supervision of all local authority capital expenditure financed by borrowed moneys, and would give added point to the implication in para. 97 that as few difficulties as possible should be placed in the way of local authority borrowing. There would be no need for restriction, for the total sum which might be raised by any authority would already be defined, and each proposal to increase it would require Government approval.

118. It is clear that few general conclusions can be reached upon a matter which may depend so much on changing local circumstances. As a general proposition, however, it is clear that the necessity for the maintenance of a real reserve varies in proportion to the intensity of the loan liabilities of the local authority concerned. Secondly, the necessity to maintain a reserve is to some extent lessened where facilities exist for raising money quickly (*e.g.*, by bill or promissory note). It may be a question worth consideration as to whether existing powers to hold investments are not too wide. The two viewpoints expressed in paras. 105-106 may be reconciled by stating that the exponents of the second viewpoint hold that the actual real reserve required is an amount constantly varying in sympathy with market conditions and local circumstances (*e.g.*, contemplated capital expenditure, impending stock maturities and so on).

119. This analysis is not pursued to the theoretical conclusion that if reborrowing could not be effected it would be impossible to realise investments, and that real reserves would thus be useless. The reason for discarding this analysis is that so many circumstances exist in which real reserves would obviously be of real value. For instance, permanent borrowing may be postponed during periods of falling interest rates without recourse to large bank overdrafts. Again, maturing mortgage investments may be used in times of high interest rates to avoid public borrowing at all.

120. A brief summing-up may, however, be attempted on the following lines. There should be (1) effective Government control of all expenditure proposed to be defrayed from loan; (2) an upper

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limit for the loan debt of individual authorities; and (3) extended facilities for local authorities to finance approved expenditure. The actual real reserve to be maintained would then be a matter for decision and continuous review by each authority in the light of existing circumstances from time to time.

G.—THE SPECIAL CASE OF THE LONDON COUNTY COUNCIL

121. It has been considered preferable to deal separately with the case of the London County Council on account of the immense size of the transactions involved. So far as reserve, superannuation and insurance funds are concerned, out of a total credit balance of £7,903,984, £2,590,365 is held in L.C.C. Stocks.

122. There is no loans pool, and sinking funds (with one very small exception) are externally invested. Stock redemption funds, however, are used internally, this being the only case where the Council have powers to use their funds internally. (It is understood, however, that powers are now being applied for to use other funds for the Council's own capital purposes.) Stock redemption funds used amount to £23,542,371, or 18.43 per cent. of the gross debt, and repayment is made by annual instalments over periods fixed each year when advances are made. Stocks mature at various dates from 1941 onwards.

123. The balance of the last stock to mature—the $3\frac{1}{2}$ per cent. Metropolitan Consolidated Stock, in 1929—was not fully repaid at maturity. Approximately £8 millions was converted in 1929, £7 millions had previously been purchased, and only £2 millions was repaid at maturity.

124. The Comptroller of the London County Council has been good enough to supply a print of a minute dated 22nd October, 1929, giving a historical resumé of the Council's financial policy in connection with this $3\frac{1}{2}$ per cent. stock, and the following excerpts from the minute are given:—

(1) "During the last 25 years of the stock period the Council followed the practice of purchasing and cancelling the stock with the moneys of the sinking fund, but it became evident as time went by and the sinking fund increased, that it could not be wholly utilised in this way. Much of the stock was firmly held; large purchases tended to raise the price of the security and the price at which it could be obtained was one of the elements governing purchases by the Council . . ."

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(2) " Alternative methods of employing the sinking fund in meeting the Council's capital expenditure and in loans to local authorities served for a while, but in the later years of the stock period the term for which the money could be employed became so short that such methods did not offer an adequate solution to the question of dealing with the large sums available "

(3) " During the war the policy was pursued, primarily on patriotic grounds, of investing the sinking fund to the fullest extent in war stocks and bonds, even though it involved a heavy overdraft from time to time in the sinking fund attached to the $3\frac{1}{2}$ per cent. Metropolitan Stock regarded as a separate entity. The result was that by March, 1920, about 10 years from the maturity date, the Council was holding upwards of £10 millions of such securities, earning a higher rate of interest than was being paid on the stock, which by that time had been reduced by purchase and cancellation to some £14,500,000 outstanding."

" Further purchases of stock for the sinking fund in subsequent years reduced the amount outstanding to £10,600,000 at 31st March, 1928, at which date the amount of the liquid investments held against this stock was £8,450,000 "

(4) " For some time previously to this the question of converting part of the maturing security had been prominently before us. The Council needed further money, mainly for its housing schemes, and it appeared to be good financial policy, instead of paying off the $3\frac{1}{2}$ per cent. security (which could have been wholly redeemed out of the sinking fund) and issuing a new loan to meet the fresh capital requirements, to issue a conversion loan which had the effect of setting free the sinking fund to meet the new capital expenditure without drawing new money from the public. This was, moreover, an economical means of providing the money required as the cost of underwriting a new loan was eliminated "

(5) " The average price paid for stock purchased and cancelled throughout the 60 years was just under £97 per £100 of stock, upwards of £7,000,000 having been cancelled in this way. There is no doubt that the policy of utilising the sinking fund liberally in purchasing and cancelling the stock has had a good effect upon the credit of the Council."

125. The following comments may be made, though at the risk of generalising from a particular case. The magnitude of the London County Council's financial operations is to a considerable extent, however, an answer to this criticism. As regards—

(1) The use of sinking funds for purchase and cancellation of stock cannot be adopted as a definite practice. Nor would this be logical, having regard to the fact that the security granted is the whole land, rents, property and revenues of the Council. This, of course, implies that earmarking has no standing from the lender's viewpoint.

(2) This is generally true under any system, but is less likely to constitute a difficulty where a loans pool exists and the whole funds of the Council are administered with regard to its whole liabilities and commitments. For instance, where the annual capital expenditure of an authority exceeds the annual amounts provided for debt redemption, there can be no difficulty in finding an outlet for the amounts so provided (if statutory powers exist).

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(3) This constitutes a special case, but can be used to exemplify the futility of earmarking. Actually the Council held investments to an amount greater than the sinking fund, the difference being made up by overdraft. The same illogicality may be quoted here as in (1).

(4) The effect of (4) was really to use sinking funds for new capital purposes.

(5) The fact here is that an authority will tend to purchase its own stock on the market if it pays it to do so, and that the beneficial effect on the Council's credit is consequential. Although it may be argued that purchases of stock on the open market should be carried out to benefit the standing of the local authority in the minds of the investing public, yet one hesitates to accept this viewpoint since, in the majority of cases, such purchases find their counterpart in a compensating increase of loan debt from some other source.

126. The real reserve held by the London County Council amounts to £1,070,814. The Comptroller of the London County Council has, however, pointed out "that even when no stock maturities are impending, this item is almost bound to fluctuate very considerably from year to year for various reasons, including the Council's requirements for capital expenditure." In addition, there is power to raise unlimited temporary loans, subject to Treasury approval, and to issue bills up to £2,000,000.

127. The inference to be drawn from the foregoing is that while the London County Council is a peculiarly important and interesting case on account of its size, yet it does not differ in principle from the other cases dealt with in the course of this report. It may be concluded that earmarking of sinking funds for purchase of stock or repayment at maturity dates is neither logical (having regard to the security granted) nor practicable (having regard to facts).

H.—CONCLUSIONS

128. It has not been possible to arrive at positive and final conclusions in respect of all the aspects of this inquiry and investigation, but on the main point of the inquiry the evidence gathered has been sufficient to justify a reasoned acceptance, for general application, of the practice of using local authority funds for new capital purposes. There should, however, be greater uniformity in the procedure governing the use of such funds, and in this connection certain rules are suggested. Among the conclusions will be found also a plea for a clearer recognition universally of the significance of the term "sinking fund," and a number of suggestions as to certain changes which appear to be desirable in the form of Government control over the borrowings of local authorities. The detailed conclusions are as follows:—

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129. *Past and present use of local authority funds.*—Landmarks in the evolution of the internal use of local authority funds are to be found in (a) the Stock Regulations of 1901, (b) the Report of the Select Committee, (c) the Superannuation Act, 1922, (d) the Accounts Regulations, 1930, and (e) Local Acts authorising the establishment of loans pools. Of these, (c) and (e) are probably the most important: (c) because it conferred a general statutory authority for the internal use of the largest and most important of all local authority funds, and (e) because it provides the only scientific and accurate method for the management of local debt, including loans from local authority funds. The gradual extension of the power of utilising sinking funds for new capital purposes has not involved any breach of the basic principles governing the loan expenditure of local authorities: all loan expenditure requires the sanction of Parliament or of a Government Department, and the expenditure must be amortised within a limited period of years. Apart from superannuation funds and housing repairs funds (the use of which is authorised by general legislation), the other funds (reserve, insurance, etc., funds) may only be used internally where powers have been obtained by local Act. There seems to be no reason why the internal use of reserve funds should not be authorised by general legislation. (Paras. 10-37.)

130. The extent to which local authority funds are used internally varies greatly among different authorities. There is evidence that the powers given by the Act of 1922 for the internal use of superannuation funds have been widely exercised; about two-thirds of the superannuation funds covered by the inquiry are invested internally. (Paras. 38-59.)

131. *Terms and conditions of internal use.*—There is lack of uniformity in the terms and conditions upon which local authority funds are used internally, and having regard to the purposes for which these funds are constituted too great an amount is invested at call—although interest is paid at a long or medium term rate. Greater regard should be had to the peculiar needs of each investing fund, and rates of interest and terms of repayment should be adjusted accordingly. It is likely that the indefinite wording of the relevant statutory enactments is, in part at least, to blame, and amendment of the law may be desirable to secure that local authority funds are, in fact, treated in the same way as ordinary lenders. The conditions under which it is suggested the use of local authority funds should be allowed are set forth in para. 67. (Paras. 60-67.)

132. *Internal use in the future.*—It is likely that the internal use

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of local authority funds will increase in the future, due to the increase in the number and amount of such funds and also to the increase in the use of the loan pooling system. The exact influence of local authority funds upon local indebtedness depends upon the uncertain trend of indebtedness, but there is no doubt that they will play an increasingly important part in the economy of local debt, with a corresponding need for additional care and skill in their investment or use. (Paras. 68-72.)

133. *The true significance of "sinking fund."*—There is need for a clearer appreciation of the meaning of the term "sinking fund"; indeed it would be preferable if some more suitable term could be found to denote the provision which a local authority is bound to make annually towards the liquidation of expenditure met out of loans. (Paras. 73-76.)

134. *The lender's real security.*—It should also be more fully appreciated that a lender is given by law certain security for his loan, and that the existence or otherwise of a specific or "attached" sinking fund is a matter which does not affect his title to repayment in the slightest degree, provided local budgets are properly framed. It may even be contended that the establishment of specific sinking funds engenders a false sense of security, since, in many cases, sinking funds calculated on statutory loan periods are quite insufficient to repay the loans concerned at maturity. (Paras. 73-76 and 95.)

135. *Redemption of stock.*—Stock sinking funds have not in general been adequate for the redemption of stocks at maturity dates; indeed the general experience is that it is a rare occurrence for a stock to be redeemed from such funds. It should, therefore, be more fully realised that in most cases the fact that stock has a definite maturity date has no real bearing upon the effective loan debt of the authority concerned. From this it is a reasonable inference that local authorities should be empowered to create and issue stock for such periods and on such terms as may be obtainable. (Paras. 77-84.)

136. *The "redemption clause" in a stock prospectus.*—Lack of uniformity exists as regards the redemption clauses in stock prospectuses. Having regard to the security afforded by law to subscribers and purchasers, it seems desirable that a standard redemption clause should be adopted relating the security given to the lender with the obligation upon the borrower to levy sufficient rates and charges to make the security operate. Such a clause is suggested in para. 94. (Paras. 85-94.)

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137. *Extension of methods of borrowing.*—To facilitate the quick and simple exercise of borrowing powers (including re-borrowing) it is desirable that greater facilities be made available for raising money by bills or promissory notes. It might be necessary to provide that, at any date, only a limited percentage (say 10 per cent.) of a local authority's loans should be in the form of such bills or notes. (Para. 97.)

138. *Superannuation funds.*—Superannuation funds form a special case, due to their size, their peculiar requirements, and to the fact that they are likely to increase in number and amount for many years to come. For the most part a long-term investment policy is required, and where superannuation funds are used internally, a suitable long-term rate of interest should be paid. (Para. 99, and see also para. 67 (3).)

139. *Investment policy.*—Provided internal loans are arranged on reasonable terms having regard to the interests of both parties to the bargain, and provided funds are possessed by or can immediately be raised by the borrowing authority to meet maturing loans (including internal loans), there seems to be no reason why local authority funds should not be utilised internally in all cases. In such circumstances a unified outside investment policy could be adopted, having regard to the whole of the loan liabilities of the authority concerned. It seems clear that loan pooling, which follows logically from a universal security, should be compulsory in the case of the larger authorities; in this event a single investment policy appears to follow as a natural sequence. (It may be necessary to make certain exceptions in practice, particularly in Scotland, where numerous trust funds are administered by local authorities; in these instances it may be necessary to adhere to a specific investment policy for each trust fund.) Internal book-keeping arrangements vary greatly, but would be greatly simplified by the universal adoption of the loan pooling system. (Paras. 100-104.)

140. *Real reserves.*—It has not been possible to arrive at a definite conclusion on the desirability or otherwise of maintaining "real reserves." There appear to be two schools of thought, one maintaining that the power to re-borrow forms a sufficient cover against maturing loan liabilities, and the other aiming at the maintenance of a reasonable investment reserve in addition. The difference is probably more apparent than real, for the term "reasonable" must be interpreted in relation to the circumstances of each case, and, as has been particularly pointed out by the London

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County Council, the amount of real reserve is bound to be a constantly varying quantity. It may be generally concluded, however, that—

(a) strict State control is desirable in all cases where it is proposed to finance expenditure from loans; both as to the amount and purpose of the expenditure, and the period within which it is to be liquidated;

(b) some limitation should exist in regard to the total loan debt of individual authorities, and it should not be possible for an authority to increase its loan debt by anything more than a reasonable percentage in order to hold investments;

(c) the fullest possible facilities should be made available to local authorities to raise money within the approved limits.

In a word, the power to incur loan expenditure should be closely regulated, but, once approved, the financing of such expenditure should be facilitated. Given these circumstances, the actual investment reserve to be maintained would be a matter within the discretion of each local authority (the reserve might vary from nothing at all up to a maximum limit) and its amount would in practice be regulated from time to time by such factors as the intensity of loan liability (*e.g.*, impending stock maturities, contemplated expenditure out of loans, trend of interest rates, proposed stock issues, and other minor factors). (Paras. 105-120.)

141. *Summary of conclusions.*—The internal use of local authority funds is increasing, and is likely to show a continuing tendency to increase; there is, therefore, need for increased care and skill in their management. Subject to regulation as to terms and conditions (which should permit of the recognition of the peculiar requirements of each fund as well as of the position of the borrowing authority), there is no reason why such funds should not all be used internally, and the adoption of this course would be consistent with the use of the loan pooling system, which, it is suggested, should be made compulsory for the larger authorities. The term “sinking fund” is something of a misnomer, and attention should be directed to the fact that the real security of a lender to a local authority is its obligation annually to provide out of its rates and revenues adequate sums for liquidation of expenditure met from loans. This point requires particularly to be made clear in stock prospectuses, the terms of which, it is suggested, should, so far as the “redemption clause” is concerned, be standardised. Strict Government control should continue to be exercised over local expenditure proposed to be met from loans (such control being concerned with capital expenditure rather than with borrowing), but fuller facilities should be made available for the

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raising of money by local authorities. There should, however, be an upper limit for the actual loan debt of each authority, so as to place a reasonable restriction upon the amount capable of being held as an investment reserve. Within this limit, the amount of such reserve, which must necessarily vary from time to time, is a matter for each individual authority.

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APPENDIX.

TABULATIONS RELATING TO QUESTIONNAIRE.

1. A questionnaire was issued on 28th February, 1934, to 60 local authorities, viz., 48 borough councils, 5 county councils and 7 Scottish burgh councils. Replies were received from 41 of these, but in one case the information had to be discarded, being too incomplete. Thus 40 cases are included in the calculations—30 boroughs, 5 counties and 5 Scottish burghs.

2. In certain cases the information given was insufficient, due probably to the extremely elaborate nature of the questionnaire, and certain relationships and balances which should exist as between the various tables have not been fully achieved. Subject to this minor qualification, which does not seriously affect the accuracy of the figures, the questionnaires were accurately and speedily answered.

3. Except where otherwise indicated, figures are for the financial year 1932-33.

Tables.

1. Gross debt.
2. Debt maturing within five years.
3. Local authority funds used internally.
4. Investment reserves.
5. Reserve funds.
6. Superannuation funds.
7. Insurance funds.

Case No. 33 is the London County Council, which has been separately dealt with throughout.

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TABLE I. GROSS DEBT

No.	Debt maturing within 5 years from date of return		Debt maturing 5-10 years from date of return		Debt maturing after 10 years from date of return		Total £ (in thousands)	Local Authority Funds used (included in totals)		Does loans pool exist?	No.
	£ (in thousands)	%	£ (in thousands)	%	£ (in thousands)	%		£ (in thousands)	%		
1	12,221	50.7	3,643	15.1	8,258	34.2	24,122	147	0.6	Yes	1
2	18,371	71.2	3,728	14.4	3,716	14.4	25,815	1,883	7.3	Yes	2
3	4,408	47.0	601	6.4	4,361	46.6	9,370	447	4.8	No	3
4	8,680	52.4	1,698	10.3	6,178	37.3	16,556	2,055	12.4	No	4
5	4,125	69.2	708	11.9	1,128	18.9	5,961	366	6.2	No	5
6	1,127	20.1	377	6.7	4,098	73.2	5,602	432	7.7	Yes	6
7	2,593	53.6	1,488	30.8	756	15.6	4,837	199	4.0	No	7
8	423	6.4	1,231	18.7	4,920	74.9	6,574	(note a)	—	Yes	8
9	5,020	44.8	173	1.6	6,008	53.6	11,201	395	3.5	No	9
10	4,264	56.9	436	5.8	2,793	37.3	7,493	536	7.2	Yes	10
11	2,754	38.5	1,120	15.6	3,282	45.9	7,156	459	6.4	No	11
12	8,010	62.4	565	4.4	4,254	33.2	12,829	1,560	12.2	Yes	12
13	(b) 2,317	47.3	505	10.3	2,078	42.4	4,900	148	3.0	No	13
14	1,298	41.3	57	1.8	1,790	56.9	3,145	103	3.3	No	14
15	2,181	71.1	69	2.2	817	26.7	3,067	—	—	No	15
16	1,994	44.4	27	0.6	2,465	55.0	4,486	534	11.9	No	16
17	1,365	32.6	902	21.5	1,926	45.9	4,193	57	1.4	No	17
18	2,501	41.7	87	1.5	3,407	56.8	5,995	356	5.9	Yes	18
19	4,790	79.5	490	8.1	750	12.4	6,030	97	1.6	Yes	19
20	647	38.1	59	3.5	990	58.4	1,696	—	—	No	20
21	1,206	42.5	487	17.2	1,142	40.3	2,835	89	3.1	Yes	21
22	1,483	83.9	232	13.1	53	3.0	1,768	85	4.8	No	22
23	902	47.4	164	8.6	839	44.0	1,905	87	4.6	No	23
24	37	1.5	118	4.7	2,359	93.8	2,514	—	—	No	24
25	5,137	82.7	183	2.9	894	14.4	6,214	599	9.6	No	25

Sinking Funds, &c., for Capital Purposes

26	26	1,435	58.7	217	8.9	791	32.4	2,443	—	—	No	26
27	27	780	27.7	517	18.4	1,514	53.9	2,811	139	4.9	No	27
28	28	474	40.4	69	5.9	629	53.7	1,172	115	9.8	No	28
29	29	989	46.0	65	3.0	1,097	51.0	3,151	9	0.4	No	29
30	30	1,041	34.1	229	7.5	1,784	58.4	3,054	20	0.7	No	30
31	31	29	2.6	130	11.7	953	85.7	1,112	133	12.0	No	31
32	32	22	0.6	1,573	40.6	2,282	58.8	3,877	58	1.5	No	32
33	33	1,901	13.8	576	4.2	11,314	82.0	13,791	37	0.3	Yes	33
34	34	535	13.3	522	13.0	2,965	73.7	4,022	73	1.8	No	34
35	35	5,398	98.4	1	0.0	89	1.6	5,488	1,042	19.0	Yes	35
36	36	5,058	78.1	61	0.9	1,357	21.0	6,476	244	3.8	Yes	36
37	37	13,366	75.7	1,127	6.4	3,159	17.9	17,652	1,300	7.7	Yes	37
38	38	2,091	84.0	—	—	396	16.0	2,487	117	4.7	Yes	38
39	39	1,343	91.0	28	2.0	105	7.0	1,476	111	7.5	Yes	39
40	40											40
Totals		132,316	52.0	24,263	9.5	97,597	38.5	254,276	14,092	5.5		
33		10,867	8.5	10,189	8.0	106,597	83.5	127,753	26,132	20.5	No	33

Notes :—(a) Local Authority funds used as from 1/4/33.

(b) Figures relate to 1933/34.

General Notes :—1. In a few cases, assumptions have been made as to Stock Maturity dates (e.g., where options exist).

2. The treatment of instalment loans has not been absolutely consistent.

3. Total of Local Authority Funds used is subject to certain qualifications—See Table 3.

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TABLE 2 — DEBT MATURING WITHIN 5 YEARS FROM DATE OF RETURN

	Types of Debt				Total (in thousands)	Real reserve held by Local Authority (or by Loans Fund if such exists) (in thousands)	No.
	Stock (in thousands)	Mortgages, Housing Bonds, etc. (in thousands)	Temporary Loans, Bills, Bank Overdraft, etc. (in thousands)	Local Authority Funds (in thousands)			
1	£	£	£	£	£	£	1
2	264	11,606	291	60	12,221	Nil	2
3	—	16,488	—	1,883	18,371	1,696	3
4	1,601	2,359	—	448	4,408	883	4
5	1,000	7,188	—	492	8,680	1,056	5
6	1,300	1,915	552	358	4,125	Not stated	6
7	—	1,127	—	—	1,127	792	7
8	—	2,561	32	—	2,593	Not stated	8
9	—	423	—	—	423	228	9
10	2,599	1,658	739	24	5,020	1,798	10
	878	2,624	225	537	4,264	546	
11	—	2,294	—	460	2,754	Not stated	11
12	905	5,496	49	1,560	8,010	1,246	12
13	(a)	2,315	—	2	2,317	Not stated	13
14	—	1,109	86	103	1,298	103	14
15	1,000	1,148	33	—	2,181	348	15
16	—	1,565	331	98	1,994	Not stated	16
17	—	1,225	113	27	1,365	328	17
18	500	1,495	150	356	2,501	182	18
19	—	4,694	—	96	4,790	239	19
20	—	614	33	—	647	Not stated	20
21	—	1,041	—	90	1,206	176	21
22	75	1,468	4	11	1,483	141	22
23	—	815	—	87	902	Not stated	23
24	—	37	—	—	37	160	24
25	—	5,088	—	49	5,137	Not stated	25

Sinking Funds, &c., for Capital Purposes

26	—	1,435	—	—	—	1,435	121	26
27	—	645	—	—	135	780	Not stated	27
28	—	438	29	—	7	474	Not stated	28
29	—	963	17	—	9	989	III	29
30	—	1,012	19	—	10	1,041	Not stated	30
31	—	28	—	—	1	29	Not stated	31
32	—	22	—	—	—	22	558	32
34	1,762	137	—	—	2	1,901	1,629	34
35	—	523	—	—	12	535	Not stated	35
36	—	4,212	143	—	1,043	5,398	Not stated	36
37	—	4,475	583	—	Not stated	5,058	Nil	37
38	—	11,796	451	—	1,119	13,366	2,222	38
39	—	1,852	122	—	117	2,091	Nil	39
40	—	1,041	191	—	III	1,343	7	40
Totals	11,884	106,932	4,193	4,193	9,307	132,316	14,570	—
%	9.0	80.8	3.2	3.2	7.0	—	11.0	—
33	—	5,023	—	—	5,844	10,867	1,071	—

Notes :—

(a) Figures relate to 1933/34.

General Notes :—

1. As in Table 1 certain assumptions have been made as to Stock maturity dates.
2. See Table 1, note 3.
3. The item "Reserve" (col. 7) requires some qualifications—see Table 4.

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TABLE 3—LOCAL AUTHORITY FUNDS USED INTERNALLY.

No.	Nature of Fund					Total (as in Table 1)	No.
	Reserve Funds (in thousands)	Sinking Funds (in thousands)	Superannuation Funds (in thousands)	Insurance Funds (in thousands)	Other Funds (in thousands)		
1	£	£	£	£	£	£	1
2	—	(b)	95	45	7	147	2
3	355	(b)	1,399	129	—	1,883	3
4	98	(a)	136	—	213	447	4
5	265	1,575	189	21	5	2,055	5
6	60	302	4	—	—	366	6
7	20	(b)	397	11	4	432	7
8	—	175	—	—	24	199	8
9	—	(b)	—	—	—	(to be used as from 1/4/33)	9
10	168	159	236	—	—	395	10
11	102	102	263	—	3	536	11
12	606	220	127	10	—	459	12
13	—	(b)	820	116	18	1,560	13
14	—	(a)	148	—	—	148	14
15	15	(a)	88	—	—	(1933/34 figure) 103	15
16	—	—	—	—	—	None used	16
17	—	436	40	—	58	534	17
18	115	—	50	—	7	57	18
19	30	123	61	—	57	356	19
20	—	(b)	8	19	40	97	20
		(a)	—	—	—	—	

Sinking Funds, &c., for Capital Purposes

21	21	—	(b)	80	—	—	9	89	21
22	22	23	—	—	70	13	61	85	22
23	23	—	(a)	—	—	—	4	87	23
24	24	—	599	—	—	—	—	—	24
25	25	—	—	—	—	—	—	599	25
26	26	—	(a)	—	—	—	—	—	26
27	27	—	(a)	136	—	—	3	139	27
28	28	—	(a)	62	—	—	—	115	28
29	29	53	—	—	—	—	—	9	29
30	30	—	9	—	—	—	—	20	30
31	31	—	—	20	—	—	—	—	31
32	32	—	—	73	—	—	60	133	32
33	33	—	27	31	—	—	—	58	33
34	34	—	(b)	—	—	—	37	37	34
35	35	—	(a)	73	—	—	—	73	35
36	36	—	(b)	273	—	27	—	1,042	36
37	37	742	(b)	11	—	14	—	244	37
38	38	219	(b)	291	—	—	66	1,300	38
39	39	1,003	(b)	39	—	19	27	117	39
40	40	32	(b)	—	—	7	69	111	40
40	40	35	(b)	—	—	—	—	—	40
Totals		3,941	3,727	5,220	432	772	14,092		
%		28.0	26.4	37.0	3.1	5.5			
33		153	23,542	2,246	191		26,132		33

Note—(a) These are cases where no loans fund exists and sinking and redemption funds have been used. It has not been possible to ascertain the exact amounts so used, i.e., the sums which would have required to be borrowed had resort not been made to these funds.

(b) Loans pools exist and consequently there are no sinking funds to use.

TABLE 4.—INVESTMENT RESERVES.

No.	Nature of Reserve					Total Reserve (See Table 2) (in thousands)	Percentage of Reserve to Gross Debt	No.
	Local Authority Stocks (in thousands)	Local Authority Mortgages (in thousands)	Government Stocks (in thousands)	Treasury Bills, T.L.s., Cash and Bank (in thousands)	Other Investments (in thousands)			
1	£ —	£ —	£ —	£ —	£ —	Nil	—	1
2	1	151	1,504	20	20	1,696	6.6	2
3	6	748	56	73	—	883	9.4	3
4	187	624	159	84	2	1,056	6.4	4
5	—	—	—	—	—	Not stated	—	5
6	100	19	589	67	17	792	14.1	6
7	—	—	—	—	—	Not stated	—	7
8	109	74	27	18	—	228	3.5	8
9	104	1,651	—	12	31	1,798	16.1	9
10	—	546	—	—	—	546	7.3	10
11	—	—	—	—	—	Nil	—	11
12	25	225	981	—	15	1,246	9.2	12
13	—	103	—	—	—	Not stated	—	13
14	—	347	—	—	—	103	3.3	14
15	—	—	—	1	—	348	8.0	15
16	—	—	—	—	—	Not stated	—	16
17	83	203	—	17	25	328	7.9	17
18	—	—	—	182	—	182*	3.0	18
19	4	60	2	64	109	239	3.9	19
20	—	—	—	—	—	Not stated	—	20
21	—	—	—	176	—	176	6.0	21
22	—	—	—	141	—	141	8.0	22
23	—	—	—	—	—	Not stated	—	23
24	—	—	—	12	—	160	6.4	24
25	92	10	46	—	—	Not stated	—	25

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TABLE 5. RESERVE FUNDS.

No.	Total at Credit of Reserve Fund	Invested		Not Invested
		Externally	Internally	
	£ (in thousands)	£ (in thousands)	£ (in thousands)	£ (in thousands)
1	641	327	55	259
2	454	—	355	99
3	158	5	153	—
4	866	476	265	125
5	179	—	60	119
6	337	266	20	51
7	Nil	—	—	—
8	252	175	—	77
9	—	Not stated	—	—
10	203	1	168	34
11	232	—	103	129
12	614	—	605	9
13	66	13	—	53
14	147	98	15	34
15	64	64	—	—
16	194	100	93	1
17	146	67	7	72
18	458	225	170	63
19	152	56	32	64
20	44	—	—	44
21	73	1	8	64
22	50	10	22	18
24	114	65	—	49
25	50	—	—	50
26	92	43	—	49
27	51	35	12	14
28	123	43	52	28
29	37	20	—	17
30	166	88	—	78
36	742	10	732	—
37	389	45	219	125
38	2,361	842	733	786
39	32	—	32	—
40	35	—	35	—
Totals %	9,522	3,075 32.3	3,936 41.3	2,511 26.4
33	602	393	153	56

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TABLE 6. SUPERANNUATION FUNDS.

No.	Total at Credit of Fund	Invested		Not Invested
		Externally	Internally	
	£ (in thousands)	£ (in thousands)	£ (in thousands)	£ (in thousands)
1	100	—	95	5
2	1,428	—	1,399	29
3	466	327	135	4
4	256	64	189	3
5	4	—	4	—
6	841	434	397	10
8	3	2	—	1
9	378	118	235	25
10	265	—	264	1
11	129	—	127	2
12	827	—	820	7
13	204	54	139	11
14	102	14	88	—
16	42	—	40	2
17	58	4	50	4
18	82	20	61	1
19	148	136	8	4
21	100	18	80	2
23	86	8	70	8
24	90	88	—	2
26	92	91	1	—
27	138	—	136	2
28	105	41	62	2
29	72	70	—	2
30	21	—	20	1
31	83	—	73	10
32	140	88	31	21
34	374	336	—	38
35	225	142	73	10
36	276	—	273	3
37	12	—	11	1
38	1,032	733	299	—
39	40	—	40	—
Totals %	8,219	2,788 33.9	5,220 63.5	211 2.6
33	6,787	4,215	2,246	326

Sinking Funds, &c., for Capital Purposes

TABLE 7. INSURANCE FUNDS.

No.	Total at Credit of Fund	Invested		Not Invested
		Externally	Internally	
	£ (in thousands)	£ (in thousands)	£ (in thousands)	£ (in thousands)
1	98	46	47	5
2	134	—	120	5
4	69	40	2	8
5	1	—	—	1
6	47	31	11	5
9	23	21	—	2
11	11	—	10	1
12	116	—	116	—
13	1	—	—	1
19	30	1	19	10
22	2	—	1	1
23	23	5	13	5
24	7	7	—	—
26	2	—	—	2
34	6	6	—	—
36	27	—	27	—
37	20	3	14	3
39	19	—	19	—
40	7	—	7	—
Totals	643	160	434	49
%		24.9	67.5	7.6
33	515	320	191	4



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